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Chair of Market Law and Regulation

The Wirecard case: Challenges for German and European
supervision

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Abstract

The Wirecard scandal demonstrated serious failures of supervision at all levels in Germany, and consequentially in the European Union. The aim of this thesis is to analyze the events that led to the Wirecard's collapse and to discuss the consequences on the German and European supervisory system. The deficiencies in the Wirecard case concerned both internal supervisions, carried out by the management and the supervisory board, and external supervision, carried out by the auditing firm and the national supervisory bodies. The most critical oversight issue in the Wirecard case identified by this research was the overprotective behavior of the German Federal Financial Supervisory Authority (BaFin) towards Wirecard, the German fintech giant. In addition to explaining the causes that led to Wirecard's debacle, the thesis offers recommendations and suggestions for reforms that could be implemented to prevent scandals such as this one from happening again in the future. The Wirecard's collapse showed that the supervision of European markets – as it is organized today – is still too vulnerable as it incentivizes national supervisors to defend national top companies. European regulators should embrace the lessons that the Wirecard case has taught in order to make European markets' supervision more and more harmonized and consequently make these markets converge to a Single European Market.

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1. Introduction

The aim of this thesis is to analyse the implications of the collapse of Wirecard, one of the biggest economic failures in Europe since the end of World War II. Wirecard was a financial services company, flagship of the German fintech market, listed since 2018 on DAX 30, the German market segment that contains the 30 most valued German companies. Wirecard has been the victim of a series of allegations by journalists and investors since 2008, which began in 2008 and lasted until it filed for bankruptcy on 25 June 2020, when it came to light that €1.9 billion in its balance sheet, was missing and probably never existed; it caused the value of its shares to immediately drop by more than 95%, from €92.4 per share to €1.4 per share. Wirecard's bankruptcy was the first case in the DAX 30 history in which one of its constituents became insolvent. The collapse of Wirecard demonstrated to European markets their vulnerability to accounting fraud and the inability of supervisors to ensure compliance with legal requirements, thereby undermining investor confidence in the proper functioning of regulated markets.

In the following chapters, my analysis will go into detail about this collapse by presenting the scenario and context in which the events took place, explaining how Wirecard operated and generated profits, chronologically analyzing the events and deficiencies that led to the failure of the German fintech giant, and finally reporting on the reactions to Wirecard's collapse and what the lessons to be learnt are, in order to contribute to the improvement of the supervision of European capital markets and avoid similar scandals in the future.

To fully understand the critical issues that led to the failure of the German DAX spearhead, in the first chapter, I will analyse the legal background and the context in which the events took place.

First, I will introduce the **European System of Financial Supervision (ESFS)** and its constituent bodies. ESFS is improperly called a *supervisory* system because its role is primarily that of a *regulator* engaged in the development of rules and best practices for the proper functioning of regulated markets rather than in the actual supervision of the correct rules application; it is involved in direct supervision only in peculiar cases, such as the supervision of specific financial entities. Some of the bodies that make up the ESFS are the **European Supervisory Authorities (ESAs)**, which are responsible for the formation of the Single Rulebook and the development of guidelines for the proper functioning of regulated markets but have limited power to intervene directly. One tool that the European Union has made available to the ESAs to enable them to express their judgement and dispense advice on the events that characterize regulated markets are the **Peer Reviews** and, after the 2019 ESAs reform, the **Fast-Track Peer Reviews**. These reviews are assessments of compliance with the guidelines issued by the ESAs, and I will illustrate them later, as they will become fundamental in the analysis of the adequacy of supervision in the Wirecard case.

Afterwards, I will present the **Committee of European Auditing Oversight Bodies** (CEAOB), which is the European body in charge of coordinating national oversight bodies of audit firms and harmonizing audit rules; it aims at raising audit quality standards.

Next, I will present the directives and regulations in force in the European Union that played a key role in the collapse of Wirecard. These directives and regulations refer to three different topics: market abuse, disclosure of financial information, and short selling. The directive and regulation in force to protect the market against **market abuse** have become essential as the fraud perpetrated by Wirecard can be considered as market manipulation. In fact, the company, by publishing false financial statements, has influenced the price of its securities and manipulated the market. Moreover, the German Federal Financial Supervisory Authority has repeatedly used these rules to accuse of market manipulation the perpetrators of the accusations against Wirecard. This over-protective behavior of the German supervisory body – dictated by a kind of *home country bias* – will gain fundamental importance in the analysis of the deficiencies that led to Wirecard's bankruptcy.¹ Subsequently, I will present the **Transparency Directive**, which is the law that sets out all the requirements that companies listed on European regulated markets must follow for **proper financial reporting**; the directive ensures a constant flow of information to the market from its participants (e.g., through mid-year and annual financial reports). This directive is of utmost importance for the analysis of the Wirecard case as all the critical issues linked to the scandal refer to incorrect and misleading financial reporting, which does not comply with the aforementioned directive. Finally, the last regulation worthy of note is the one that regulates the power of intervention by national supervisory authorities with respect to **short selling**. This regulation gives the National Competent Authorities (NCAs) the power to intervene by instituting temporary bans on short selling when economic stability is at risk. The **Short Selling Regulation** will play a significant role in the Wirecard case because, in February 2019 Wirecard's securities were subject to a short selling ban issued by the German supervisory authority following a drop in the price of the securities of around 40% of their value, which could have threatened market stability.

After giving a brief explanation of the key European directives and regulations for the Wirecard case, I will carefully analyse the functioning of Germany's national system of supervision of regulated markets, scilicet those bodies that directly supervise participants in regulated markets. In Germany the system of supervision is characterized by a *Two-Tier financial reporting enforcement procedure* with two National Competent Authorities (NCAs): the **Financial Reporting Enforcement Panel (FREP)** – a private company recognised by the German Ministry of Finance, which is in charge of conducting the first tier of examinations – and **Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)** – a German public company reporting directly to the Ministry of Finance (MoF), which intervenes only in exceptional cases for the second tier of examinations. Wirecard's case showed that something in the German supervisory system did not work. The two supervisory

¹ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

bodies were not able to identify the fraud before it was too late. Moreover, the BaFin intervened several times in defense of Wirecard, denouncing the perpetrators of the accusations and attacks on the German fintech champion. These attacks and accusations against Wirecard almost always came from abroad, as most of them are contained in articles of the Financial Times (FT), and in fact BaFin's over-protective behavior can be seen as a kind of *home country bias*: the need of the German supervisor to protect the German fintech flagship from attacks from abroad. Instead of analyzing and investigating the allegations against Wirecard, BaFin has repeatedly denounced the perpetrators, claiming that their aim was to manipulate the market by publishing false data in order to decrease the value of Wirecard's securities.

To conclude the first chapter, I will present the audit market in Germany, who its participants are and what their weights in terms of market share are. The audit market acquires a key role in the Wirecard case because it is the auditing companies that are entrusted with the task of verifying the accuracy and correctness of the financial statements published by listed companies and therefore their compliance with the requirements of the Transparency Directive. Finally, I will present the body responsible for the supervision of audit firms in Germany: the **Audit Oversight Body (AOB)**. Its objective is to ensure that audit firms perform their work in accordance with the applicable rules, in order to guarantee an adequate standard of audit quality.

In chapter two, I will present the protagonist of the scandal: Wirecard. I will introduce the company and trace its success story, from its foundation to its entry into the DAX 30 in 2018, the year in which Wirecard reached its highest market valuation. I will also provide a contextualization of Wirecard within the European fintech market, analyzing its market share. After that, I will present Wirecard's figures to explain how the company generated its profits and how it operated. Finally, I will conclude this chapter by doing a deep dive on the functioning of the Third-Party Acquirers (TPAs), used by Wirecard to operate as a payment processor also in countries where it did not have a banking license; it is precisely through its complex network of TPAs that Wirecard was able to carry out its fraud. Due to the high complexity of Wirecard's operations and the fact that Wirecard operated in distant geographical locations (i.e., Asia), it was more difficult for the supervisory authorities to identify the fraud².

In the third chapter, I will provide the reader with a detailed timeline of the events that have characterized the history of Wirecard from its foundation in 1999 until today.

² Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre.*

Subsequently, I will focus more on those events that are most important for the narrative of Wirecard's collapse, from the incredible success of the first few years, through the numerous accusations received since 2008, to the bankruptcy proceedings filed on 25 June 2020 and the subsequent arrest of CEO Markus Braun. I will then further analyse the failures that led to the final collapse of the German fintech giant, from information problems to supervisory failures. I will first explain the problems related to the malfunctioning of the information flow, because too many times clear signals and accusations that should have set off alarm bells about Wirecard were ignored. Sometimes, such allegations had the opposite effect to the one intended: in some cases, BaFin –instead of investigating the veracity of the allegations made against Wirecard – prosecuted the perpetrators, not only discouraging others from reporting any accounting irregularities identified but also contributing to convincing investors that such allegations were unfounded. BaFin's intervention had another distortive effect on the market when it instituted the short selling ban on Wirecard's securities in February 2019, as it limited Wirecard's securities volatility only on one side – it was forbidden to sell the securities, not to buy them – obstructing the markets from incorporating all the information necessary to establish the true market value of the securities.

Then, I will present the critical aspects of Wirecard's internal control system and supervisory board – the market's first line of defense against accounting fraud – that were unable to prevent the falsification of financial statements and thus the fraud that misled investors. I will focus my analysis on investigating whether adequate control systems were in place within Wirecard and whether the supervisory board was able to adequately fulfil its role.

Afterwards, I will comment on the deficiencies related to the external audit, as the audit firm engaged to audit Wirecard's accounts (i.e., Ernst & Young) was unable to detect fraud for several years (about twelve years). I will first try to comprehend whether there were failings on the part of Ernst & Young (EY), also considering that its audit of Wirecard's financial statements focused primarily on mere compliance with accounting standards and not on the detection of frauds. EY –like BaFin and FREP – is guilty of failing to give proper weight to the alarm bells that emerged regarding the health of Wirecard's accounts. One of the causes that may have contributed to the poor audit quality is the lack of competition in the audit market.

Finally, I will analyse the criticalities related to the German supervisory system trying to understand if the behaviors of FREP, BaFin and AOB were adequate. I will mainly focus on analyzing whether BaFin and FREP acted correctly during the supervision of Wirecard in carrying out their functions within the two-tier financial reporting enforcement procedure.

Subsequently, in chapter four, I will report on the findings and recommendations that emerged from the Peer Review (PR) and the Fast-Track Peer Review (FTPR) conducted by ESMA in July 2017 and November 2020. The 2017 Peer Review was not specifically focused on BaFin and FREP but instead was a review

conducted by ESMA to assess the level of harmonization of national supervisory procedures among 31 different eurozone countries. In the 2020 FTPR, however, ESMA was mandated by the European Commission to form a Peer Review Committee (PRC) to specifically assess the adequacy of BaFin and FREP in carrying out their supervisory role in relation to the Wirecard case. As I mentioned earlier, ESMA is engaged in the development of guidelines that national supervisors should implement to ensure proper supervision of capital markets. In particular, the authority is engaged in the development of the Guidelines on Enforcement of Financial Information (GLEFI) which are best practices that national supervisory authorities should put into practice to ensure proper supervision of financial information disclosed by listed companies. In both the PR and the FTPR, ESMA assesses the harmonization of the various national supervisory systems by evaluating the NCAs' compliance with the Guidelines issued by ESMA. The GLEFIs cover several topics and during its analysis ESMA focuses on the compliance with those it considers most important. I will focus in my research on those that this thesis has identified as most relevant in the Wirecard case (GLEFIs 2, 5 and 6): the adequacy of the number and professionalism of the resources employed by the two NCAs, the adequacy of the level of independence of the two NCAs vis-à-vis government and issuers, and finally the adequacy of the selection and examination method used by FREP and BaFin in their supervisory process.

Finally, to conclude the fourth chapter, I will present possible actions and reforms that could be undertaken to prevent scandals such as Wirecard's from happening again in the future.

The Wirecard case should not become another forgotten financial scandal, as it is crucial not to waste the opportunity to learn important lessons from this collapse that could contribute to the improvement of the European supervisory system.

Finally, in the fifth and final chapter, I will discuss the conclusions of my thesis, tracing Wirecard's history to identify the most critical deficiencies and their possible solutions.

2. Supervision architecture and market defense regulation

First of all, in order to better understand the reasons behind Wirecard's collapse, it is essential to explain the context in which it took place. In this chapter, I will present the actors involved in the supervision and protection of markets at European and national level. More specifically, I will focus on what their powers are, how they are structured, the distribution of tasks and responsibilities, and the main Directives and Regulations of the legal framework of the European capital market supervision.

I will start by introducing the supervisory bodies of European regulated markets, and then I will analyze the European System of Financial Supervision (ESFS), which is erroneously called the financial *supervisory* system because the role played by its constituent bodies is mainly the one of *regulators*, while the actual supervision of the correct rules application is a responsibility of the National Competent Authorities (NCAs).

The bodies of the ESFS have a direct supervisory role only in particular cases, such as the one of the European Securities and Markets Authority (ESMA), which has a direct supervisory role in the supervision of Credit Rating Agencies (CRAs). It is critical to understand that ESMA acquires a fundamental importance in the Wirecard affair because, as I will illustrate in [Paragraph 2.1.1](#), the independent EU authority is engaged in the development of the guidelines that national supervisory bodies should respect in order to reach an adequate level of market supervision harmonization. More specifically, in the Wirecard case, the Guidelines on the Enforcement of Financial Information (GLEFI), or rather, the guidelines to be followed in the area of financial reporting, acquire a fundamental role. In fact, the investigation conducted by ESMA (i.e., Peer Reviews and Fast-Track Peer Reviews) is based on the compliance with the GLEFI. However, these guidelines are not binding rules and national supervisors are not obliged to apply them. In fact, as I will show in [Paragraph 2.3.1](#), BaFin and FREP were not able adhere to all the GLEFIs issued by ESMA.

After illustrating the ESFS and its bodies, I will present the European audit oversight body: the Committee of European Auditing Oversight Bodies (CEAOB). This body's task is to harmonize EU's rules on audit oversight and coordinate the various Public Oversight Bodies for Statutory Auditors (POBSAs), the national bodies responsible for the effective supervision of audit firms.

For the readers to fully understand the context of the Wirecard case, I will also analyze the directives and regulations in force in Europe that played a key role in the company's collapse.

I will first present the directive and regulation in force to protect the market from market abuse – the **Market Abuse Directive II** (MAD II) and the **Market Abuse Regulation** (MAR) – as they have gained importance in

the Wirecard case. In fact, BaFin filed diverse complaints for market manipulation against the market participants who had previously accused Wirecard of fraudulent accounting activities.

Another directive that needs to be mentioned is the **Transparency Directive**, which sets out all the necessary requirements for proper financial reporting, ensuring a constant flow of information to the market by its participants. This directive is particularly important because all the critical issues linked to the Wirecard scandal are related to incorrect and misleading financial reporting.

The last noteworthy regulation – the EU Regulation on Short Selling and Certain Aspects of Credit Default Swaps (**Short Selling Regulation** – SSR) – applies to short selling and it provides NCAs with the power to intervene by instituting temporary bans on short selling when economic stability is at risk. This regulation will gain a significant role in the Wirecard case in February 2019, when BaFin issued a short selling ban on Wirecard's securities following a drop in the price of the securities of approximately 40% of their value.

For the purpose of the analysis conducted in this thesis, I will present Germany's national competent authorities (NCAs) for market supervision. The NCAs are responsible for the actual supervision of capital market participants' compliance with legal obligations and the audit firms' compliance with high accounting standards.

While analyzing German capital markets' supervisory system, I will focus on its Two-Tier financial reporting enforcement procedure, describing the two bodies involved in the process: the Financial Reporting Enforcement Panel (**FREP**) and the Bundesanstalt für Finanzdienstleistungsaufsicht (**BaFin**).

In the last paragraph, I will present the German audit market and its main players, focusing on the low level of competition that characterizes this market. Finally, I will analyze the body in charge of supervising the correct audit firms' compliance with accounting audit standards: the Audit Oversight Body (**AOB**).

2.1 European supervision architecture

2.1.1 European System of Financial Supervision (ESFS): European Systemic Risk Board (ESRB) and European Supervision Authorities (ESAs)

In the first place, it is essential to investigate the international context, at EU level. The European supervisory system was established only a few years ago; it was proposed in 2009 by the European Commission, after the start of the US subprime mortgages crisis that triggered the global financial crisis of 2007-2008. This crisis had serious repercussions on global financial stability and exposed deficiencies in financial supervision as a whole. In Europe, the crisis demonstrated that the national supervision models in place at the time – which

were totally unharmonized – were inadequate and outdated, as they could not keep pace with the complexity of European markets, which are characterized by a high degree of globalization and by financial actors operating among themselves through dense, often cross-border, networks. The financial crisis has also exposed shortcomings in the cooperation, coordination, consistent and correct application of the EU legal framework; moreover, it brought to light the low level of trust between the various national supervisory authorities among the Member States³.

In 2009, in order to respond to the aforementioned deficiencies, the Single Rulebook was introduced with the aim of bringing together all the harmonized prudential rules and best practices for the financial sector that applied across the European Union.

Moreover, in 2010, the **European System of Financial Supervision (ESFS)** was introduced, and it has been operating since 2011, with the tasks of supervising European markets and, through its member authorities, helping to develop the rules and best practices to be included in the Single Rulebook. The main duties of the ESFS are to ensure consistent and appropriate supervision of the financial markets across all European countries and to protect investors against the increasingly innovative challenges posed by finance⁴. The ESFS supervision is divided into two different levels: Micro-Prudential and Macro-Prudential, which are composed of different bodies with different tasks each.

The **macro-prudential supervision** deals with the supervision of the financial system as a whole. Its main purpose is to prevent or mitigate risks to the entire financial system; it is carried out by the **European Systemic Risk Board (ESRB)**. The ESRB is composed by representatives of the European Commission, the European Central Bank (ECB), EU's national central banks and EU's National Competent Authorities (NCAs)⁵.

The principal duties of the ESRB are:

- Collect and analyze relevant information to identify systemic risks;
- Issue warnings when systemic risks are considered significant;
- Issue recommendations for action in response to identified risks;
- Monitor the follow-up to warnings and recommendations;
- Cooperate and coordinate with ESAs and international forums.

The **micro-prudential supervision** deals with the supervision of individual institutions, such as banks, insurance companies and pension funds. This type of supervision is carried out by **European Supervisory**

³ Demarigny F., McMahon J., and Robert N. (2013). Review of the new European System of Financial Supervision (ESFS). *Directorate-General for International Polices*.

⁴ European Commission official website (2022). Search for “*European System of Financial Supervision*”.

⁵ European Council official website (2019). Search for “*Financial supervision: Council confirms position ahead of negotiations with Parliament*”.

Authorities (ESAs), whose main objective is to harmonize financial supervision across the EU. To this end, they are responsible for developing the Single Rulebook and a set of prudential standards for individual financial institutions. The ESAs help to ensure consistent application of the rulebook to create a level playing field. They are also responsible for assessing risks and vulnerabilities in the financial sector⁶.

EU's three Supervisory Authorities are:

- European Banking Authority (**EBA**)⁷;
- European Insurance and Occupational Pensions Authority (**EIOPA**);
- European Securities and Market Authority (**ESMA**).
-

It is critical to mention that to ensure cross-sectoral consistency within these bodies in the development and application of the single rulebook, the Joint Committee of the ESAs was created. The ESFS structure is further clarified by the image below (Figure 1).



Figure 1 – Source: European Council, 2019⁸

Since 2019 the ESAs' review began and a new, major reform has been studied and its implementation has already started, even though it is still ongoing: the European Union witnessed the arrival of new players and the introduction of new objectives of harmonization and market protection.

⁶ European Council official website (2019). Search for "Financial supervision: Council confirms position ahead of negotiations with Parliament".

⁷ European Banking Authority (EBA) is given a leading role in coordinating and monitoring the fight against money laundering and terrorist financing (AML) at European level. The mandate covers not only the banking sector but the entire financial sector and aims to optimize EBA's expertise and resources and recognizes the systemic impact of money laundering and terrorist financing risks on the banking sector.

⁸ European Council official website (2019). Search for "EU system of financial supervision".

When looking at the reform, people should take into account the primary role that sustainable finance and FinTech technologies are gaining in the development of the financial system.

The new competences entrusted to the ESAs are⁹:

- Identification and related reporting of risks that environmental, social and governance factors pose to financial stability;
- Promotion of consistency between financial market activities and sustainability objectives;
- Provision of guidance on how to effectively integrate sustainability issues within relevant EU financial legislation;
- Promotion of the consistent implementation of such EU legislation.
- Furthermore, when initiating and coordinating EU-wide assessments of the resilience of financial institutions in conditions of adverse market developments, the ESAs should take into account the risks that environmental, social and governance factors might pose to the financial stability of institutions.

To entirely attain the evolution of the discussion, it is essential to grasp the key roles of the ESAs:

- Promoting convergence of behavior among EU member states' national supervisors;
- Delivering and spreading best practices among competent authorities;
- Delivering and spreading best practices among financial authorities, institutions and market participants.

Even if ESAs are defined as *supervisory* authorities, it can be noted that they have more of a *regulatory* role, since they are focused on the development of the Single Rulebook and on the sharing of best practices, while the term supervision usually refers to the implementation of such rules and best practices. The actual supervisory role is mostly in the hands of National Competent Authorities, even though ESMA (an ESA body) has a direct supervisory role in the supervision of specific financial entities.

For the purpose of narrating the Wirecard case, I will focus on the ESA that was most involved in the events – the **European Securities and Markets Authority (ESMA)** – which contributes to safeguarding the stability of the EU financial system by strengthening investor protection and striving to maintain stable and orderly capital markets through advice and through the development of best practices.

ESMA carries out four different activities to achieve its objectives¹⁰:

⁹ European Commission official website (2019). Search for “*Capital Markets Union: Creating a stronger and more integrated European financial supervisory architecture, including on anti-money laundering*”.

¹⁰ ESMA official website (2022). Search for “*ESMA in brief*”.

1. **Assess risks to investors, markets and financial stability:** The objective is to promptly identify weaknesses, risks and, where possible, opportunities so as to be able to react in the best way possible. ESMA identifies market trends and developments that endanger financial stability, the orderly functioning of markets or that pose risks to investor protection. ESMA plays a risk assessment role for investors: it promotes transparency by making information available to investors and, when necessary, by issuing advice and warnings to them. ESMA's risk assessments contribute to the systemic work undertaken by the European Systemic Risk Board (ESRB), which focuses on stability risks in financial markets.
2. **Contribute to the development of the Single Rulebook for EU financial markets:** ESMA's main task is to develop the Single Rulebook for EU financial markets with the aim of creating a level playing field for issuers and investors to enhance the European single market. ESMA accomplishes this task through the advices it issues and the technical standards it develops.
3. **Promote supervisory convergence** among the 27 Member States, which consists in using similar approaches for all EU countries, through the application and implementation of similar if not identical rules. The objective of such harmonization is to prevent regulatory arbitrage between member states and thus ensure harmonized supervision and regulation; ESMA performs this duty in close contact with the NCAs. ESMA is qualified to conduct peer reviews, establish EU data reporting requirements, thematic studies and joint work programs, and draft opinions, guidelines and Q&As; as well as to build a close network that can share best practices and train supervisors.
4. **Directly supervise specific financial entities:** The last of ESMA's tasks is to directly supervise specific financial entities, such as:
 - Credit Rating Agencies (CRAs);
 - Securitization Repositories (SR);
 - Trade Repositories (TRs).

ESMA's four activities are closely intertwined, as one of them has the potential to influence all the others. For example, insights gained from risk assessment may feed into the work on the single rulebook, supervisory convergence, and direct supervision.

Supervisory convergence is considered to be the main outcome of the implementation and application of the single rulebook. One of the key tasks that ESMA performs – as mentioned earlier – is the development of the guidelines that supervisory bodies should put into practice to ensure proper supervision of capital markets (GLEFIs). These guidelines contain the best practices that should be followed by the NCAs for the correct supervision of the compliance with the *Transparency Directive* requirements of the financial

information provided by issuers whose securities are admitted to trading on regulated markets¹¹. The Guidelines on the Enforcement of Financial Information (GLEFIs) will acquire a fundamental importance later on as it is precisely on the compliance with these GLEFIs that ESMA has based the Peer Review conducted in 2017 and the Fast-Track Peer Review conducted in 2020 on the functioning of the German two-tier financial reporting enforcement procedure.

ESMA's coordination is divided into different working groups, some of which are more regulatory in nature – those involved in the harmonization of rules across the EU and the development of GLEFIs – while others more operational – such as those involved in conducting Peer Reviews and Fast-Track Peer Reviews¹².

All policy decisions of ESMA are taken by the Board of Supervisors. The Board guides the work of the Authority and has the ultimate decision-making responsibility regarding a broad range of matters including the adoption of ESMA technical standards, opinions, guidelines, and the issuance of advice to the EU institutions. In addition to the ESMA Chair, the Board of Supervisors is composed of the heads of EU's National Competent Authorities (NCAs) and the European Economic Area (EEA) responsible for securities regulation and supervision with non-voting representatives from the European Commission (EC), the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Free Trade Association Surveillance Authority (EFTA Surveillance Authority)¹³.

ESMA, like the other ESAs, has been subject to the 2019 review process. The new provisions are applicable from 1 January 2020, and they have provided ESMA with new powers and tools. In fact, following the ESAs Review, ESMA can set up coordination groups on defined topics where there may be a need for coordination in relation to specific market developments. Supervisory convergence tools such as Q&As and peer reviews and the new Fast Track Peer Review additions have been improved. ESMA is tasked with preparing the EU's strategic supervisory priorities.

The review of the ESAs requires ESMA to consider 3 issues of high relevance in the conduct of its activities¹⁴:

- **Sustainable finance:** ESMA will have to consider environmental, social and governance risks.

¹¹ ESMA staff (2014). Guidelines, ESMA Guidelines on enforcement of financial information. *ESMA*.

¹² Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

¹³ ESMA official website (2022). Search for “Board of supervision and NCAs”.

¹⁴ ESMA official website (2022). Search for “ESA Review”.

- **Technological Innovation:** ESMA will have to consider and contribute to the development of a common European approach towards technological innovation; it will also promote information sharing between NCAs on cyber threats and contribute to the Union’s financial data strategy.
- **Proportionality:** before taking action, ESMA will have to take into consideration the nature, scale and complexity of risks, business practices, business models and the size of financial actors and markets.

Having concluded the analysis of the bodies responsible for the supervision of regulated markets at European level, in the next paragraph I will present the European audit oversight body: the Committee of European Auditing Oversight Bodies (CEAOB).

2.1.2 European audit supervision: CEAOB

In order to talk about audit oversight at the European level, it is necessary to first mention the European Regulations and Directives that were introduced a few years ago.

The new legal framework on audit oversight was introduced in 2014 (in force since 2016), and it consists of an Audit Directive and an Audit Regulation, which replaced the legal provisions in force until now: the Statutory Audit Directive, dated 2006. Firstly, these legal provisions revised and updated the definition of **Public Interest Entities (PIEs)** and, secondly, with the aim of limiting excessive familiarity between audit firms and audited companies to effectively reduce possible conflicts of interest, they established stricter requirements for such entities¹⁵.

The new PIEs definition includes:

1. Companies with transferable securities listed on regulated markets in the EU and governed by the law of an EU member state – this requirement mirrors the one previously provided in 2006;
2. Credit institutions authorized by the authorities of EU member states – the requirement is essentially the same as in the previous Statutory Audit Directive, except that member states can no more exempt unlisted PIEs from the requirements of this category;
3. Insurance undertakings authorized by the authorities of EU member states – as in the previous point, the requirement is essentially the same as in the previous Statutory Audit Directive, except that member states may no longer exempt unlisted PIEs from the requirements in this category;
4. Other entities that a member state may choose to designate as PIEs, this requirement mirrors the one previously provided in the 2006 laws.

¹⁵ European Commission official website (2022). Search for “*Committee of European Auditing Oversight Bodies*”.

In addition to the new definition for PIEs, with the aim of increasing cooperation between member states, the Audit Regulation introduced a new body, the **Committee of European Auditing Oversight Bodies** (CEAOB). The CEAOB has a coordination purpose between the 27 different national audit oversight bodies, named Public Oversight Bodies for Statutory Auditors (POBSAs). Introduced through the Audit Regulation in 2016, the CEAOB aims to facilitate the harmonization of oversight in order to apply European audit legislation more effectively and consistently. Among its tasks there are: the review of effective implementation and enforcement of audit rules within Europe, the monitoring of market quality and competition in the provision of audit services to PIEs, and the technical review of International Standards on Auditing (ISAs).

The need for CEAOB's legislative harmonization duty arises from the coexistence of different audit oversight systems on European soil. In fact, the 27 member states are highly heterogeneous: some states have a professionally self-regulated oversight system, part of them adopts a system characterized by public oversight structures, and other states use a mixed system where audit companies cooperate with the public oversight in the supervision process¹⁶.

Despite the restructuring of auditor oversight systems carried by the new European Directive, and despite the CEAOB's efforts to harmonize the different oversight systems, there are still many differences in the quality of audit supervision among EU's member states that undermine harmonization.

The CEAOB is thus the new body that the European Union is relying on to try to achieve greater harmonization in audit oversight, following the objectives of the EU legislation introduced in 2016. We will now focus on CEAOB's composition and tasks.

The CEAOB is composed of¹⁷:

- Representatives of the European Economic Area (EEA): the EEA includes EU countries and Iceland, Liechtenstein and Norway, allowing them to be part of the EU's single market. Each country of the EEA has one representative within CEAOB; EU member states are represented by national POBSAs, while Iceland, Liechtenstein, and Norway are served by three other representatives. I will present examples of national Public Oversight Bodies on Statutory Audit in the next chapter when we'll talk about national supervision structure. For example, in Germany it is the Audit Oversight Body (AOB) and in Italy it is the CONSOB.
- The European Securities and Markets Authority (ESMA): as already mentioned, it contributes to preserving EU's financial stability and maintaining stable and orderly capital markets.

¹⁶ Garciaosma B., Gisbert A., and Navallas B. (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

¹⁷ European Commission official website (2022). Search for "Committee of European Auditing Oversight Bodies".

There are two more bodies that have a strict relationship with the CEAOB: the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) have the task of observing the Committee. In fact, they don't have any operational tasks, as they only have to observe the actions implemented by the CEAOB and express their opinion on the adequacy of those actions.

CEAOB's structure is summarized by the image below (Figure 2).

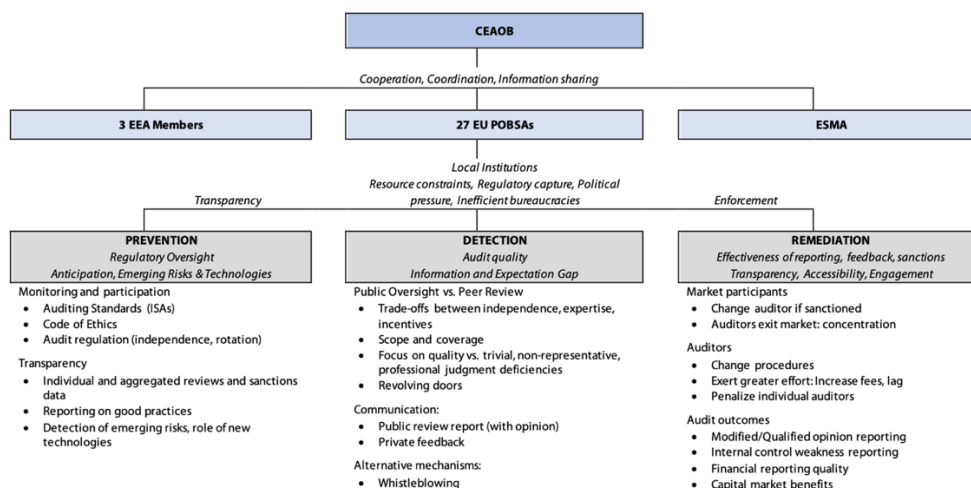


Figure 2 – Source: Garciaosma B. et al., 2020¹⁸

The CEAOB fosters the convergence of practice by European audit regulators and the improvement of audit quality within Europe in order to increase the level of trust towards informative, reliable, and independent audit reports.

The CEAOB main tasks are to¹⁹:

- Consistently support audit quality and consequently keep and increase investors' confidence and trust towards financial reporting in the European Union;
- Promote common understanding of inspection methodologies, international standards framework, and enforcement processes;
- Provide framework for cooperation among POBSAs;
- Promote the intensification of dialogue with stakeholders about audit quality;
- Enhance dialogue with audit networks.

As shown, there are many supervisory bodies in Europe, each with specific tasks and powers, but all with the main objective of harmonizing the rules between European countries and making the European market increasingly unique, preventing unfair competition between countries and increasing investor protection.

¹⁸ Garciaosma B., Gisbert A., and Navallas B. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

¹⁹ European Commission official website (2022). Search for "Committee of European Auditing Oversight Bodies".

In the next paragraph, I will present the key Directives and Regulations in force in Europe during the development of the Wirecard case, created by European regulators to pursue supervisory harmonization.

2.2 European market defense regulation

With regard to the legislative framework for the proper functioning of capital markets in Europe, I will now analyse some of the directives and regulations in force in Europe with the aim of protecting market and investors from fraud and market abuse. It is important for the reader to note that this thesis does not presume to report all European laws in this field, but to analyse only those that were most relevant during the Wirecard case. In fact, the main European directives and regulations implicated in the Wirecard scandal are specific and cover three main topics: the **protection of investors from market abuses** since, during the course of the affair, BaFin will make repeated recourse to these regulations and directives in the complaints issued against market participants for market manipulation; the respect of strict rules on the disclosure of financial reports to the public by listed companies because most of the criticisms of the Wirecard case are related to the failure in complying with the requirements of the Transparency Directive, which imposes the obligations to publish financial reports (e.g., annually, half-yearly); and finally the **regulation of short selling**, which can be banned for limited periods of time if there is a potential threat to market stability, relevant because BaFin used this tool in February 2019 to prevent short selling of Wirecard securities.

In the course of the next paragraphs, I will therefore discuss the functioning of these regulations and directives, and I will point out how they gained importance during the course of events that characterize the Wirecard case.

2.2.1 MAR and MAD II

As regards the legal framework on **market abuse** in Europe, I will now present the regime in force since July 2016, which replaced the previous one made in 2003. The market abuse is regulated by various rules:

- Market Abuse Directive II²⁰ (MAD II): European Directive that deals with criminal sanctions harmonization for market abuse across EU countries (DIRECTIVE 2014/57/EU).

²⁰ The MAD II replaced the previous directive, introducing (DIRECTIVE 2014/57/EU):

- Common EU definitions for market abuse offences such as insider dealing, unlawful disclosure of information and market manipulation;
- A common minimum set of criminal sanctions for insider dealing/market manipulation and unlawful disclosure of insider information;
- The concept that legal entities (companies) may be held liable for market abuses

- Market Abuse Regulation²¹ (MAR): European Regulation with direct effect in EU countries, whose objective is to standardize market abuse regulations across different EU countries (REGULATION (EU) No 596/2014).
- Several Delegated Regulations that deal with specific issues set out in MAR are often based on Technical Standards set out by ESMA.
- Guidelines drafted by ESMA and national regulators (i.e., GLEFIs). It is important to specify that their observance is not mandatory - they are best practices which should be followed by supervisors to ensure a correct market supervision.

The principal Market Abuse behaviors detected in the MAR are: insider dealing based on the concept of inside information²², unlawful disclosure of inside information²³ and, market manipulation. The EU Market Abuse Regulation (MAR) expands the civil offence of market abuse (insider dealing and market manipulation) to cover all financial instruments traded on and off regulated markets in Europe, and prohibits the use of manipulative devices, misleading practices and the misuse of inside information within the trading of these instruments, with the aim of providing the market with more transparency and stability²⁴. I will focus on the last case of market abuse, market manipulation, which is the issue identified in the Wirecard case. With regard to market manipulation, the MAR identifies two potential cases:

- **Information-Based Manipulation** includes – but is not limited to – spreading false rumors to induce trading by others, as well as disseminating information that gives false or misleading signals about the supply or the price of a financial instrument leading to an artificial price level (REGULATION (EU) No 596/2014).
- **Transaction-Based Manipulation** involves instances where an individual – or a group of individuals – knew or should have known that his or her actions could affect the pricing of a security, for example transactions that artificially affect prices to give the impression of a price

²¹ The MAR replaced the previous regulation, introducing (REGULATION (EU) No 596/2014):

- Broader market abuse rules, to include abuse on electronic trading platforms;
- A prohibition of abusive behavior on high frequency trading platforms;
- A market abuse offence for the manipulation of benchmarks;
- A prohibition on market abuse in commodity and related derivative markets;
- Stronger institutional cooperation between financial and commodity regulators.

²² Insider dealing arises when a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates (also the cancelling or amending of an order could be considered insider trading if consequent to the use of inside information). It's also prohibited to give recommendations to another person on the basis of inside information to engage in insider dealing (or cancel or amend an order) or to induce another person to engage in insider dealing (or cancel or amend an order), where the person using the recommendation or inducement knows or ought to know that it is based upon inside information (REGULATION (EU) No 596/2014).

²³ It arises where a person possesses inside information and discloses that information to any other person, except for when the disclosure is made in the normal exercise of an employment, a profession, or duties (REGULATION (EU) No 596/2014).

²⁴ Kern A., and Maly V. (2016). The new EU market abuse regime and the derivatives markets.

movement in a financial instrument, ending up in manipulating the security price, and therefore the market (REGULATION (EU) No 596/2014).

Thus, the objective of the MAR and MAD is to decrease the information asymmetry that exists between the insiders of a certain listed company and the outsiders of the same. However, such an objective of completely eliminating any information asymmetry between insiders and outsiders – even if limited only to corporate information – would in any case be utopian. First, if the listed company could not keep any information confidential, issuers might prefer not to be listed on a regulated market anymore. Secondly, and more importantly, it is unrealistic that the set of information available to the market (outsiders) is as comprehensive as that of insiders²⁵.

After analyzing the content of MAR and MAD II, it is now clear that these regulations and directives have acquired a fundamental importance in the Wirecard case, since BaFin has repeatedly used these European laws to issue market manipulation complaints against the authors of the accusations against Wirecard. Indeed, BaFin – in order to protect the German fintech champion – has repeatedly issued market manipulation complaints against market participants. The complaints issued by BaFin concerned both types of market manipulation: information-based and transaction-based manipulations. For example, BaFin accused some Financial Times journalists of **information-based manipulation** because they had previously published some articles containing accounting fraud accusations towards Wirecard; from BaFin's point of view, the FT journalists were guilty of aiming at Wirecard's security price to decrease through the dissemination of false information. As I will explain in [Paragraph 4.1](#), BaFin also accused Wirecard of information-based manipulation, because the company was able to influence the security market price through the disclosure of fraudulent financial statements. Moreover, BaFin also accused some market participants (i.e., Zatarra) of **transaction-based manipulation**, accusing them of a short selling attack against Wirecard. Market manipulations occur most commonly in illiquid and poorly regulated markets (such as the fintech market); these markets have the least stringent transparency rules and thus the greatest information asymmetries between manipulators and other market participants²⁶.

2.2.2 Transparency Directive

Regarding the preservation of transparency for listed companies in Europe, the Transparency Directive (DIRECTIVE 2004/109/EC) was issued in 2004 and amended in 2013. In fact, this directive requires issuers of

²⁵ Di Noia C., and Gargantini M. (2009). The Market Abuse Directive Disclosure Regime in Practice: Some Margins for Future Actions. *Rivista delle Società*, No. 4/2009.

²⁶ Veil R., and Schweiger R. (2017). European Capital Markets Law.

securities traded on any European regulated market to provide the public with a flow of regulated data and information on a regular basis (e.g., quarterly, half-yearly, yearly) through financial reports. The **Transparency Directive** improves the **harmonization of financial information requirements** among EU member states. The aims of this amendment are to establish minimum requirements regarding the disclosure of financial information all over the European Union, and to increase transparency at the capital markets, and to increase investor protection to meet information deficits in a developing financial market environment²⁷. The obligation to share financial information contributes to the proper functioning of the markets, as can be read in the text of the Directive: *“Efficient, transparent and integrated securities markets contribute to a genuine single market in the Community and foster growth and job creation by better allocation of capital and by reducing costs. The disclosure of accurate, comprehensive, and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency”* (DIRECTIVE 2004/109/EC).

In order to provide greater protection to investors, the Transparency Directive was amended by Directive 2013/50/EU in October 2013. This amendment was deemed necessary to regulate new types of financial instruments with an economic effect similar to holding shares and rights to acquire shares, which could be used to secretly acquire shares in companies, leading to market abuse and giving a false and misleading picture of the economic ownership of listed companies²⁸.

In 2019, researchers at the Journal of International Accounting Research conducted a study to assess the effectiveness of the Transparency Directive, before and after its amendment. These researchers used stock return synchronicity as a proxy for stock price informativeness. Through this indicator, they assessed how much the market price more accurately reflected the actual stock price using the information provided to the market through TD. According to this study, the Transparency Directive of 2004 had a positive effect on the market by increasing price informativeness and thus providing the market with more accurate prices. Moreover, the 2013 amendment not only confirmed the results of the previous directive but even improved them; this confirms that improving corporate transparency contributed to more efficient capital markets²⁹.

In this field, ESMA's only task is to promote harmonized application across the EU through advice and the development of common procedures. In addition to the provisions regarding the publication of a constant flow of information, the TD imposes on all member states the obligation to establish a supervisory body that

²⁷ ESMA official website (2022). Search for *“Transparency Directive”*.

²⁸ Veil R., and Schweiger R. (2017). European Capital Markets Law.

²⁹ Watanabe O. V., Imhof M., and Tartaroglu S. (2019). Transparency Regulation and Stock Price Informativeness: Evidence From the European Union's Transparency Directive.

regularly examines the financial statements of listed companies and takes action against the authors of such violations³⁰. This requirement to establish a supervisory body does not specify that it must be a single body, but leaves it up to member states to decide; in Germany this task is carried out by two supervisory bodies. Financial reports published by listed companies in Germany are subject to scrutiny for compliance with accounting standards and legal requirements, not only by private auditors (i.e., EY) in the first instance, but also – on a random but risk-adjusted basis – by FREP, and also by BaFin, as I will discuss in [Paragraph 2.3.1](#). Audit firms are responsible for verifying that the financial reports published by the audited company comply with the accounting standards of the Transparency Directive.

In Germany, the FREP's analysis serves to verify that the audit conducted on the financial reports is reliable and trustworthy. If FREP finds incorrectness or the examined company refuses to cooperate with the private entity, FREP can request the direct intervention of BaFin, which is the ultimate body with the task of verifying compliance of the examined company's financial reports with the Transparency Directive requirements.

In the Wirecard case, neither the auditing companies nor the national supervisory authorities were able to enforce the Transparency Directive and thus to identify fraud and prevent bankruptcy. It is indeed around this directive that the most serious deficiencies occurred. Moreover, the fact that Wirecard operated in such distant geographical locations and that its core business was characterized by a high technological component made it more difficult to ascertain the data contained in financial reports and to be actually able to supervise the consolidated financial statements. In fact, it is important to note that the high technological component allows the use of very long supply chains, with the presence of many interconnected actors, and it is clear that in this circumstance – which is also worsened by geographical reasons – it makes supervision even more difficult³¹. Wirecard's failure to comply with the Transparency Directive is what made it possible for the company to commit the multi-billion Euro fraud. In the following chapters, I will analyse in detail the deficiencies in the audit and supervision of the audit of financial reports.

2.2.3 Short Selling Regulation

Finally, as regards **short selling**, the EU regulation on short selling and certain aspects of credit default swaps has been in force in Europe since 2012 (REGULATION (EU) No 236/2012).

A short sale is the sale of a security that is not owned by the seller at the time of the sale but with a commitment to buy the security back in the future. There are two different types of short sales: *covered*

³⁰ Christensen H. B, Hail L., and Leuz C. (2021). Capital-market effects of securities regulation: The role of implementation and enforcement. *Boston, USA: National Bureau of Economic Research*.

³¹ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

short selling, where the seller has already planned to borrow the securities from someone before the sale; *naked short selling*, which occurs when the seller has no arrangements to borrow the securities before the sale. According to the Short Selling Regulation, naked short selling of shares and instruments of sovereign debt is prohibited.

As can be noted from these few lines extrapolated from the text of the Regulation, the main objective is to harmonize the rules on short selling in the 27 Member States in order to ensure the proper functioning of the financial markets in times of instability: *“To ensure the proper functioning of the internal market and to improve the conditions of its functioning, in particular with regard to the financial markets, and to ensure a high level of consumer and investor protection, it is therefore appropriate to lay down a common regulatory framework with regard to the requirements and powers relating to short selling and credit default swaps and to ensure greater coordination and consistency between Member States where measures have to be taken in exceptional circumstances. It is necessary to harmonize the rules for short selling and certain aspects of credit default swaps, to prevent the creation of obstacles to the proper functioning of the internal market, as otherwise it is likely that Member States continue taking divergent measures.”* (REGULATION (EU) No 236/2012).

In addition, the objective of the Regulation is to increase transparency on investors' short positions in securities traded on regulated markets in the EU and to ensure that NCAs have adequate powers of intervention to mitigate the risks associated with uncovered short selling that could threaten financial stability. On the one hand, a tightening of market transparency duties or restrictions on short selling, subject to the double test that (a) the facts constitute a "serious threat to the financial stability or market confidence" of one or more Member States; and (b) the measure is "necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to the benefits". On the one hand, a tightening of market transparency duties or restrictions on short selling, subject to the double test that (a) the facts constitute a "serious threat to the financial stability or market confidence" of one or more Member States; and (b) the measure is "necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to the benefits"³². This regulation therefore provides national competent authorities with the power to temporarily restrict or even ban short selling in one or more financial instruments in order to safeguard financial stability. A NCA may only carry out such an intrusive intervention if certain circumstances are met: *“there are adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State concerned or in one or more other Member States; and the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its*

³² Lucantoni P. (2020). Dottrina e giurisprudenza commentata. *Rivista di diritto bancario (Fascicolo III, Sezione I)*.

benefits." (REGULATION (EU) No 236/2012). ESMA drew a positive preliminary conclusion in its assessment of SSR: it found that the introduction of the Regulation had some positive effects in terms of improving market transparency and reducing the risks of settlement failure in EU financial markets. However, ESMA saw a number of possibilities for improving SSR. Regardless of the content of SSR, it should be viewed positively that the regulation of short selling and CDS has at least overcome national fragmentation by creating a truly European regulatory regime³³.

The Short Selling Regulation was of particular importance during the Wirecard case: in February 2019, BaFin issued a short selling ban on Wirecard's securities following a drop of approximately 40% in the value of its securities, aiming to mitigate risks towards economic stability as a whole. This intervention had a distorting effect on the market: in fact, the short selling ban is an asymmetric intervention because the sale of the securities subject to this intervention is prevented, but not their purchase. According to a study conducted by the Cato Institute – one of the world's top 15 *Think Tanks*³⁴ – banning short selling is similar to cutting off the right to vote "no", leading to a distortion of the resource allocation process. That research concluded that: "the benefits of stock selling and buying freedom outweigh the short-run uncertain benefits of artificially propping up particular companies' stock prices and partially reducing volatility"³⁵.

If a NCA applies a short selling ban, ESMA is asked to give its opinion on the appropriateness of the measure. ESMA issued its opinion also on BaFin's short selling ban arguing that there were indeed risks to financial stability as a whole, and therefore considered such intervention appropriate³⁶.

The most recent European example of a NCA's use of this tool is the short selling ban exercised by Consob (Commissione Nazionale per le Società e la Borsa) on 16 March 2020, during the COVID-19 pandemic, following a 36% collapse of stocks listed on the Italian stock market³⁷. This intervention was followed by similar interventions by other European national authorities during the same period.

In the following paragraphs, I will present the supervisory system in place in Germany to ensure the proper functioning of capital markets and auditors' compliance with accounting standards.

³³ Veil R., and Schweiger R. (2017). European Capital Markets Law.

³⁴ Think Tank, institute, corporation, or group organized for interdisciplinary research with the objective of providing advice on a diverse range of policy issues and products through the use of specialized knowledge and the activation of networks. Think tanks are distinct from government, and many are nonprofit organizations, but their work may be conducted for governmental as well as commercial clients. Projects for government clients often involve planning social policy and national defense. Commercial projects include developing and testing new technologies and new products. Funding sources include endowments, contracts, private donations, and sales of reports (Ladi, 2022).

³⁵ Copeland C. L. (2010). Short Sales Bans: Shooting the Messenger? *Cato Institute Briefing Papers No. 119*.

³⁶ ESMA official website (2019). Search for "ESMA issues positive opinion on short selling ban by BaFin".

³⁷ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

2.3 German supervision architecture

I will now present the supervisory framework in force in Germany, including the bodies involved to ensure capital markets' proper functioning and compliance with the accounting requirements to which companies whose securities are traded on regulated markets are subject.

First of all, I believe it is crucial to present the German capital market supervisory system and its particular functioning. In Germany, the supervision of compliance with legal requirements by companies whose securities are admitted to trading on regulated markets is ensured by a particular procedure called **Two-Tier financial reporting enforcement procedure**. This procedure is characterized by the cooperation of two different National Competent Authorities (NCAs): the **Financial Reporting Enforcement Panel (FREP)**, a private company recognized by the German Ministry of Finance (MoF), which is in charge of conducting the first level of examinations, and **BaFin** (Bundesanstalt für Finanzdienstleistungsaufsicht), a German public company reporting directly to the Minister of Finance, which intervenes only in exceptional cases, only if the second level of examinations is needed. I will analyse in depth the functioning of this procedure in the next paragraph, as it will be fundamental to understand the shortcomings that led to the failure of Wirecard. In fact, this procedure could have led to a delay in the detection and reaction to the scandal. In addition, the German two-tier financial reporting enforcement procedure was subject to two evaluations by ESMA: the first one in 2017, through a Peer Review; the other evaluation occurred after the scandal in 2020 through a Fast-Track Peer Review, with the aim of assessing the responsibilities of this procedure in the delays in identifying and reacting to the scandal.

Next, I will give a brief introduction of the audit market in Germany – which is characterized by a very high level of concentration – and present its main participants. Finally, I will analyse the supervisory system that ensures that audit firms in Germany meet high-enough accounting standards: the Auditor Oversight Body (AOB). It is important to note that this body plays a key role, even though it is not allowed to publish specific results of the examinations conducted on the audit firms individually (i.e., expressing an opinion for all audits performed by individual audit firms), but instead only an annual publication containing the AOB's opinions on the different audit firms on their audits in aggregate.

2.3.1 Two-Tier financial reporting enforcement procedure and National Competent Authorities (NCAs) in Germany

As mentioned before, European supervisory bodies are erroneously called “supervisory” because their primary task is to regulate, while the bodies that supervise the correct application of laws are the National

Competent Authorities (NCAs). Through their legal frameworks, EU member states implement European directives and regulations with the aim of ensuring the proper functioning of capital markets so that they can bring beneficial effects for the economic growth of society and proper allocation of resources among investors and issuers. To function efficiently, capital markets need participants and investors to have a high level of confidence that they are functioning properly and that issuers' compliance with the necessary requirements is properly supervised. Member states implement the European Directives and Regulations within their legal framework to protect market integrity and investors.

In Germany, this implementation is provided by the **Securities Trading Act** (Wertpapierhandelsgesetz, or in short WpHG). Typically, such implementation imposes stringent financial reporting and disclosure requirements on companies whose securities are admitted to trading on regulated markets. However, as mentioned above, the adoption of these laws alone is not sufficient; to ensure proper functioning of capital markets, EU member states need a supervisory system to monitor compliance with these obligations. Financial scandals such as the Wirecard scandal can undermine investor confidence in the proper supervision of capital markets by national supervisory bodies. Each member state may implement the supervisory system it deems most appropriate for monitoring compliance: Germany decided to set up a special supervisory procedure which I will now analyze in detail.

Following international accounting scandals such as Enron and Parmalat, German legislators worked to strengthen investor confidence in the correctness of companies' financial statements by introducing an additional procedure for enforcing accounting rules. Since 1 July 2005, in fact, the two-tier accounting enforcement procedure has offered an additional means of controlling companies' financial statements in Germany. This two-tier procedure envisages that responsibilities in the application of financial reporting are divided between: the German Financial Reporting Enforcement Panel (FREP), a private law entity recognised by the Ministry of Finance, which carries out the examination in the first instance, since it is not invested with public powers and bases its examination on the cooperation of the companies to be examined; and the Federal Financial Supervisory Authority (i.e., BaFin), a company invested with public powers and that therefore intervenes in particular cases – which I will expose shortly – to carry out the second tier of the examination. Being invested with public powers, BaFin is accountable and reports directly to the Ministry of Finance. It is precisely on this relationship between BaFin and the MoF that all suspicions of overprotective behavior by BaFin are based. In fact, the numerous reports, their high level of detail and their timing raise many doubts about the independence of the BaFin from the German government.

Usually, as a rule, examinations are initiated by the FREP. The FREP examines the financial statements of companies whose securities are admitted to trading on regulated markets in accordance with its defined

code of procedures to ensure that they meet accounting standards (note that the FREP's task is only to verify compliance with accounting standards, not to detect potential fraud).

The FREP may initiate the examination in the following three cases (OECD, 2013):

- When there are specific indications to presume that accounting rules have been violated (also known as an "examination for cause");
- At the direct request of BaFin;
- Without cause as part of random sampling.

In the case of an examination for cause, there must be specific factual indications; speculation, mere assumptions or hypotheses are not sufficient. FREP can use various means to reach these specific factual indications, for example, by carrying out its own research or by using media reports or suggestions received from public authorities. FREP is instructed by BaFin to carry out examinations of a company's financial statements only if it is in possession of the same specific factual indications of breaches of accounting rules. With respect to examinations carried out by FREP without cause, the companies to be examined are selected following a combined risk-based and random sampling method and, once the reference sample is formed, FREP randomly selects the company to be examined within the sample following a rotation approach, i.e., all companies must be examined within a defined period of time³⁸.

The BaFin in this first tier remains a spectator, in fact it conducts its part of the procedure, the second tier of examination, only in two particular cases (BaFin, 2019):

- if it is informed by the FREP that a company under examination refuses to cooperate with it (I remind you that the FREP, not being invested with public powers, cannot oblige companies to provide the information necessary to conduct the examination. If the company fails to provide all the necessary information, this is considered a refusal to cooperate.) or if a company whose examination has ended does not agree with the result of the examination (companies must accept the result of the examination in full, partial acceptance is not allowed).
- If it has substantial doubt as to the accuracy and adequacy of the result of the examination conducted by FREP or if it has reason to believe that FREP did not follow the procedure correctly in conducting the examination.

Once the FREP concludes its examination, it must notify the examined company of the results either if an accounting error has been detected or if no error has been detected, the companies in question in both cases must state whether or not they agree with the results published by the FREP. When BaFin begins an

³⁸ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

examination, it starts by taking into account the results and the information that has emerged and been used by the FREP during the examination. After that, BaFin starts its own examination. Unlike FREP, BaFin is invested with public powers and can therefore oblige the companies under examination to provide the information necessary to carry out the examination. Once BaFin completes its examination, it notifies the company of the results, identifying the accounting error made or otherwise stating that it has no objection. If errors have been identified, BaFin, before notifying the result, which, given the negative outcome, is equivalent to a criminal complaint, conducts a hearing with the company under examination to give it the right to state its position. If an accounting error is identified during the course of an examination, there is an obligation to publish the error in order to inform the capital markets, so as to ensure their efficiency and proper functioning. This obligation to publish the error is also seen as a form of sanction as it damages the public image of the company that committed the error.

Usually, the error is published independently by the company that has committed it; when this does not happen, it is up to BaFin to enforce this obligation, even in cases where no second-tier review has been carried out. Given that BaFin is a public body, in pursuing its duties under the financial reporting enforcement procedure, it is empowered and required to cooperate with other public authorities and bodies. In fact, if during the course of an examination, BaFin becomes aware of facts or evidence suggesting the presence of criminal offences related to corporate accounting, it is obliged to inform the competent prosecuting authority immediately. Furthermore, if the BaFin identifies an error in a financial statement that has been audited and for which an unqualified audit report has been issued, it must notify the competent authority, the Auditor Oversight Body (AOB), which I will present in the next paragraph.

Regarding the Wirecard case, the FREP correctly selected Wirecard's 2014 annual financial reports for a no-cause examination as part of random sampling, concluding this analysis in 2016 without having detected fraud. Then only in 2019 did FREP again select the 2018 mid-year financial reports for a risk-based no-cause review. During the period from 2016 to 2018 neither BaFin nor FREP selected Wirecard for an examination of its financial statements despite the very numerous allegations received by the company. In 2019, BaFin also intervened directly, shortly after FREP began its examination of Wirecard's financial statements, instructing FREP to examine Wirecard's 2018 annual financial reports. These examinations in conjunction with the forensic review conducted by KPMG, also carried out that year, will expose the accounting fraud perpetrated by Wirecard. However, it should be noted that overall, neither BaFin nor FREP were able to identify the fraud in its early stages. On the contrary, BaFin, intervened several times to protect Wirecard, the German fintech champion. In fact, during the years 2015 to 2018, BaFin repeatedly prosecuted the perpetrators of the Wirecard accusations, those who were trying to expose the fraud. In addition, BaFin also issued a short selling ban on Wirecard's securities in February 2019, following a drop in the value of the securities of about 40% of their value, to safeguard economic stability according to their communications.

This is the financial reporting enforcement procedure in force in Germany, not all EU member states apply a two-tier procedure, in fact it is a rarity.

In 2017, this two-tier financial reporting enforcement procedure was subject to an analysis during the Peer Review conducted by ESMA to assess the adequacy of financial reporting procedures and their compliance with the Guidelines on Enforcement of Financial Information in EU member countries. This analysis showed that BaFin and the German supervisory system did not comply with two guidelines issued by ESMA. Specifically, firstly, it did not consider that it directly had the power to require the re-approval of the financial statements or the publication of a Corrective Note, i.e., data supplementing or replacing those contained in the published financial statements, and secondly, BaFin raised an issue of confidentiality with respect to ESMA's guidelines on the sharing of confidential data³⁹. Citing the findings of the Peer Review conducted by ESMA in 2017, it was satisfied overall with the financial reporting procedure applied in Germany: "*The procedures in place ensure an adequate level of quality review, ensure that the relevant areas of each examination are pursued and that the conclusions reached are sound*"⁴⁰. As mentioned before, after the collapse of Wirecard in 2020, ESMA was mandated to conduct a new analysis aimed at assessing whether the behaviors and procedure used by BaFin and FREP were adequate and sufficient in the supervision of the Wirecard case through a Fast-Track Peer Review, which I will analyse later in this thesis. In the next paragraph, the last of the first chapter, I will present the audit market in Germany and the public body that oversees it, the AOB.

2.3.2 The German audit market and its oversight: Audit Oversight Body (AOB)

In this paragraph I will present the market for audit firms in Europe and more specifically in Germany. I will introduce the main players and focus on presenting the high level of concentration that characterizes this market. This is reflected in a lowering of competition in the market itself, which could generate a lowering of the level of quality of the audits carried out by the audit firms that are part of it. In fact, due to reduced competition in this market, audit firms have less incentive to provide better quality audits, as they do not need to gain new clients. Finally, to conclude this first chapter, I will introduce the last national oversight body relevant for the presentation of the context in which the Wirecard scandal took place, the Auditor Oversight Body (AOB), the body in force in Germany to ensure that auditing firms ensure that high accounting standards are met by the companies they audit.

³⁹ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre.*

⁴⁰ ESMA staff (2017). Peer Review on guidelines on enforcement of financial information. *ESMA.*

The European audit market is extremely concentrated, with only four firms accounting for more than 60% of the market share in the number of statutory audits of companies issuing securities traded on European regulated markets⁴¹. These companies are the so-called Big Four because they share the audit market: Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young and finally KPMG.

The concentration in market share increases significantly when looking more specifically at the audit market in Germany. Research into the concentration of the audit market in Germany, conducted by Audit Analytics, a company that provides high-quality audit information, showed that the top 160 companies in Germany are audited by 12 audit firms⁴². The companies in the sample are listed on the three biggest German stock markets: the first is the DAX30, consisting of the 30 largest companies on the Frankfurt Stock Exchange, with a capitalization of €13 billion; the second is the MDAX60 which has a capitalization of €28 billion and consists of 60 weighted stocks excluding technology stocks; and finally, the third is the SDAX70 with a capitalization of €12 billion and comprises the 70 largest German companies not included in the DAX30.

Auditor	# of Companies	% of Companies
1. KPMG	51	32%
2. PwC	46	29%
3. EY	31	19%
4. Deloitte	17	11%
5. BDO	6	4%
6. Ebner Stolz	3	2%
7. Rodl & Partner	1	1%
8. Grant Thornton	1	1%
9. RSM	1	1%
10. S&P	1	1%
11. Moore	1	1%
12. Mazars	1	1%

Figure 3 – Source: Brown, 2020⁴³

As shown in figure (3) of the 12 audit firms auditing the 160 largest German companies, the top four, unsurprisingly the Big Four, account for 91% of the market. In fact, with 32% KPMG takes the first place followed by PwC with its 29%, EY with 19% and Deloitte with 11% the remaining 8 audit firms lag behind and in aggregate weigh 9%. This concentration even increases when looking at the markets individually:

- DAX30 – as far as the DAX30 is concerned the concentration skyrockets, this market is in fact audited only by the Big Four with KPMG and PwC with 50% and 30% respectively, Ernst & Young follows with 17% and Deloitte closes with only 3% of the market share⁴⁴.

⁴¹ Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

⁴² Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

⁴³ Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

⁴⁴ Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

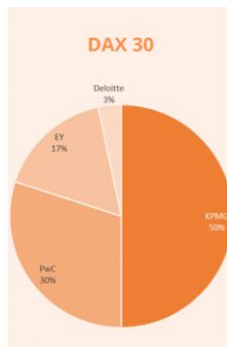


Figure 4 - Source: Brown, 2020⁴⁵

- MDAX60 - also in this market the concentration is almost total with the Big Four in the same positions but separated by less gap, KPMG 32%, PwC 28%, EY 27% and Deloitte always last with 12%. The big news compared to the previous market is the presence of a shy fifth audit firm, BDO, with 2% of the market, auditing only one company⁴⁶.

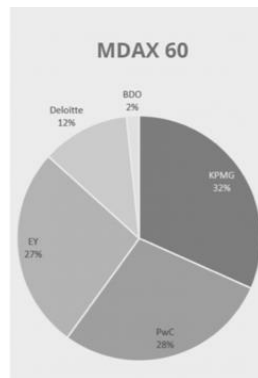


Figure 5 - Source: Brown, 2020⁴⁷

- SDAX70 - in this market the concentration decreases, and the 7 missing audit firms appear with 13% of the aggregate market, BDO increases its market share to 7% with 5 audited firms. The top four positions remain with the Big Four firms, but this time PwC is in first place with 29% followed by KPMG with 24%⁴⁸.

⁴⁵ Brown M. (2020). Who Audits Public Companies – Germany. *Audit Analytics*.

⁴⁶ Brown M. (2020). Who Audits Public Companies – Germany. *Audit Analytics*.

⁴⁷ Brown M. (2020). Who Audits Public Companies – Germany. *Audit Analytics*.

⁴⁸ Brown M. (2020). Who Audits Public Companies – Germany. *Audit Analytics*.

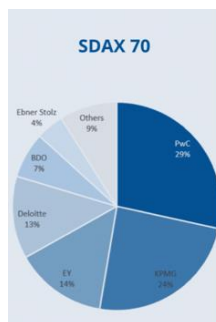


Figure 6 - Source: Brown, 2020⁴⁹

It is clear that the audit market in Europe, and even more so in Germany, is a market characterized by low competition, essentially an oligopoly. It is possible that this lack of competition may lead to a decrease in audit quality due to conflicts of interest caused by over-long relationships between the audit firm and the audited company. Europe has tried to curb this problem with the EU Audit Reform for Public Interest Entities Directive and Regulation of 2014. These provisions contain rules to limit the relationship between the audited company and the auditing firm and provide for a mandatory audit firm rotation mechanism every 10 years. Europe has also provided for special cases in which this period can be extended, for example by a further 10 years in the case of tendering. The question is whether these rules introduced by Europe are sufficient.

However, it is clear that something has gone wrong with the compliance with these rules, just think that Ernst & Young was the auditor of Wirecard from 2008 to 2020, i.e., for 12 years. One possible reform that could help to increase competition in the market for auditing firms and at the same time increase audit reliability would be the provision of an obligation on issuers of securities traded on regulated markets to submit their financial statements to a second audit process, but only to smaller auditing firms (not part of the Big Four); I will elaborate on this reform in chapter five.

In Germany, the audit market is supervised by the Auditor Oversight Body (AOB).

The AOB plays a key role in ensuring the high quality and professional standards of auditing in Germany. The Audit Oversight Body carries out periodic inspections of audit firms on a risk-based approach, considering the type and scope of the audit firm's engagements. The AOB communicates the results of its investigations to the public only once a year and the report describes the activities conducted by the AOB in aggregate; no information is published with respect to company-by-company inspections⁵⁰.

The AOB conducts annual inspections of companies that audit many PIEs, so it is not surprising that the Big Four are inspected every year. Specifically, Ernst & Young, Wirecard's audit firm is inspected annually and EY

⁴⁹ Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

⁵⁰ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

was also inspected in relation to the audit of Wirecard's financial statements but at the time neither EY nor the AOB were able to identify the fraud.

The AOB can also take action against an audit firm if it is informed by BaFin or the FREP that there are irregularities in the audits they have examined in the course of their duties. Indeed, it is important to note that the AOB carries out its task in cooperation with the other national supervisory bodies, BaFin and FREP. Since they are responsible for supervising the compliance of issuers whose securities are traded on regulated markets with the requirements of the Transparency Directive, they contribute to the supervision of the accuracy of the work of the auditing firms by reporting to the AOB any irregularities identified during the examination of audited financial statements.

3. Wirecard, a fintech company and its business model

The purpose of this chapter is to provide the reader with all the necessary information about Wirecard – the company protagonist of this scandal – to understand the analysis conducted by my research.

To this end, I will first proceed by introducing Wirecard by presenting the main events that have characterized its success story. At this stage of the thesis, however, I will focus on Wirecard's history from its foundation until the end of 2018, the year in which it reached the peak of its success and its highest market valuation, when it was admitted to the DAX 30, the most important German regulated market, I will leave the analysis of Wirecard's collapse to the next chapter. Next, I will present the market within which Wirecard operated, the payment provider market. By means of a study conducted by experts in the fintech market⁵¹, I will show what weight the German giant had in this market. In addition, I will present the European Digital Finance Strategy, adopted by the European Commission in 2020 - as part of the Digital Finance Package - to improve the quality of digital financial services offered and incentivize their use but at the same time offer greater protection to consumers of these services⁵².

Furthermore, in the last paragraph I will present the business model on which Wirecard's success story was based, the weakness that made the fraud possible. The Wirecard group carried out its operations in distant geographic areas such as Asia and operated in collaboration with many companies and partners, which made it more difficult to identify fraud and carry out the necessary controls⁵³.

More specifically, I will focus on the operation of Third-Party Acquirers (TPA), companies that were instrumental in the fraudulent scheme implemented by Wirecard. Suffice it to say that in 2016 3 Asian TPAs were responsible for 50% of sales and contributed around 95% to EBITDA⁵⁴.

3.1 Overview of Wirecard and contextualization within the fintech market

3.1.1 Wirecard: from foundation to DAX 30

The company was founded in Aschheim, a town on the outskirts of Munich in Bavarian Germany, in 1999. Wirecard is a company engaged in fintech as a provider of electronic payments. A payment provider company is an organization that facilitates financial transactions, between those who sell something and those who

⁵¹ Finch Capital & Dealroom.co (2019). The State of European Fintech.

⁵² European Commission official website (2020). Search for “*Digital finance package*”.

⁵³ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

⁵⁴ McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

must buy it – often sitting behind the scenes when you use a credit card or move money between bank accounts there is a payment provider company that guarantees the execution of that transaction. Wirecard was created with the intention of breaking the American dominance of payment providers. Wirecard wants to be the European equivalent of PayPal and immediately finds support and capital from investors.

Three years after its foundation, in 2002, Wirecard elected Markus Braun, a former KPMG consultant, to become its CEO and, in the same year, merged Wirecard with Electronic Business Systems, another German fintech company.

In 2005 Wirecard began to expand and entered the Frankfurt stock market through the acquisition of a call center on the verge of bankruptcy, InfoGenie AG. The call center company was acquired by following an uncommon procedure, as Wirecard carried out a reverse IPO, a practice that avoids the classic scrutiny required for an initial public offering. At the time of the acquisition, it had only a few hundred employees (around 300) and its core business was the processing of online payments for gambling and pornography sites.

Driven by its great success on the stock exchange, Wirecard entered the banking sector a year later, in 2006, with the purchase of XCOM, a German banking company based in Dreieich, which offered online transactions, direct banking and other banking services. In the same year, Wirecard was listed on the Tech Dax, the German stock exchange index containing the 30 largest companies in the technology sector. Through this acquisition, the Wirecard Group establishes Wirecard Bank AG as its banking arm and is immediately licensed by Visa, Mastercard and JCB. Through the possession of this licence, the Wirecard Group is now able to issue credit and debit cards directly.

Already in 2008, the first accusations began to arise, as a shareholders' association reported irregularities in the balance sheet. In the same year, Markus Braun, in order to dispel any doubts, decided to appoint EY as auditing firm, replacing the small firm of accountants that had followed Wirecard until then. Projects became increasingly international and ambitious, the company started using English as the corporate language and, over the years, made a series of acquisitions and expanded geographically, especially in Asia, where it set up its headquarters in Singapore. It later expanded further to have offices in countries such as New Zealand, Australia, South Africa, Turkey, and China. Wirecard's success on the German stock exchange continues and so the company continues with purchases and acquisitions. It acquires several opaque payment companies throughout the air through complex and ambiguously structured deals.

It was only in 2015 that the attacks and accusations against Wirecard began to intensify, when the Financial Times (FT) published the first article in its “House of Wirecard” series⁵⁵. In the article, the FT journalist accuses Wirecard of budgetary inconsistencies and claims that there is a hole in the balance sheet of over €250 million. The company immediately clears itself of any allegations through its legal department. That

⁵⁵ McCrum D. (2015). The House of Wirecard. *Financial Times*.

same year, Wirecard made its biggest acquisition to date, buying an Indian payment company for €340 million. The price paid for the Indian company immediately appeared to be very high compared to its actual value, but the purchase was completed without further problems.

The following year, in 2016, the allegations against Wirecard continued. Indeed, an anonymous group of short sellers, known under the name of Zatarra, published a report in which they accused Wirecard of money laundering⁵⁶. BaFin, the supervisory body for German regulated markets, investigates the members of Zatarra and other short sellers on suspicion of market manipulation. In the same year, Wirecard acquires the US company Citigroup, de facto entering the North American market.

In 2017, Wirecard regained the credibility and trust it had lost, due to the various allegations it had received, through the publication of a clean audit by EY. On the wave of enthusiasm Wirecard reaches its maximum capitalization, being valued at €24 billion, approximately €191 per share.

The company went from having a few hundred employees, around 300 in 2005 to having over 5,000 in 2018. In September of that same year, Wirecard takes over from Commerzbank and enters Germany's most important regulated market, the DAX 30. Wirecard is in September 2018 the largest European fintech company ever, finally able to hold its own against American fintech giants.

3.1.2 Wirecard in the European Fintech Market

Before looking at the events that caused such a strong growth and success story to degenerate, I will present the market to which Wirecard belonged, its capitalization and the capitalizations of its major competitors.

To present the fintech market and its actors, I will use a study conducted in 2019 on the state of European fintech⁵⁷. I will refer to 2019 data to provide an analysis of the market in which Wirecard operated in its heyday, just before the house of cards collapsed.

The Fintech market in Europe in recent years has realized more value than all other tech sectors as shown in the chart below (Figure 7).

⁵⁶ Zatarra (2016). Zatarra report. *Zatarra Research & Investigation*.

⁵⁷ Finch Capital & Dealroom.co (2019). *The State of European Fintech*.

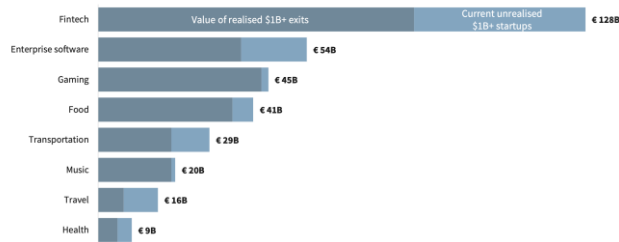


Figure 7 – Source: Finch Capital & Dealroom.co, 2019⁵⁸

In fact, the Fintech market accounts for 20 per cent of all venture capital in Europe, a significant gap from other sectors, reaching a higher percentage than in Asia and the United States, and this percentage is even higher in countries such as Germany and the UK as we can see in the graph (Figure 8).

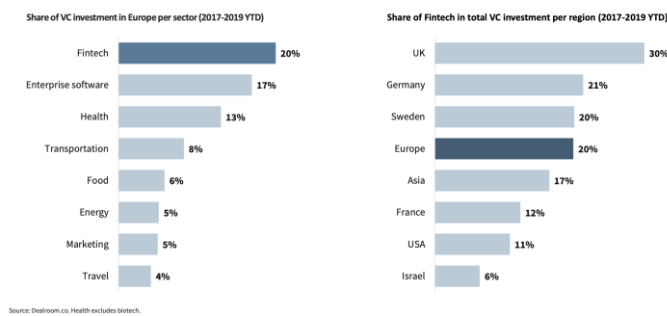


Figure 8 – Source: Finch Capital & Dealroom.co, 2019⁵⁹

As can be seen in the third graph (Figure 9), however, not only the percentage of investments is growing, but also their nominal value, and in fact we can see that European investments are around \$5B, about twice as much as those in Asia and about 50% less than US investments, which are worth about \$7.5B.

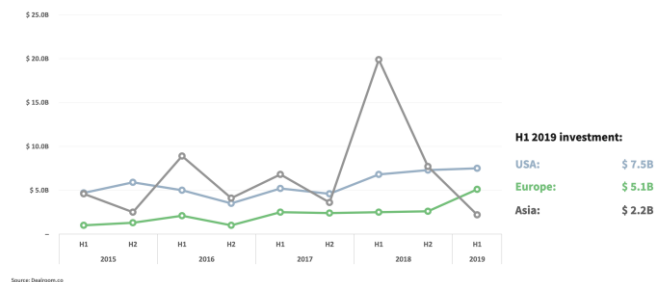


Figure 9 – Source: Finch Capital & Dealroom.co, 2019⁶⁰

⁵⁸ Finch Capital & Dealroom.co (2019). The State of European Fintech.

⁵⁹ Finch Capital & Dealroom.co (2019). The State of European Fintech.

⁶⁰ Finch Capital & Dealroom.co (2019). The State of European Fintech.

Europe in 2019 had at least one rising star in every key Fintech sector. As we can see from the first image below, the European Fintech companies are numerous and among those valued at more than 1 billion in 2019 there is also Wirecard (Figure 10).

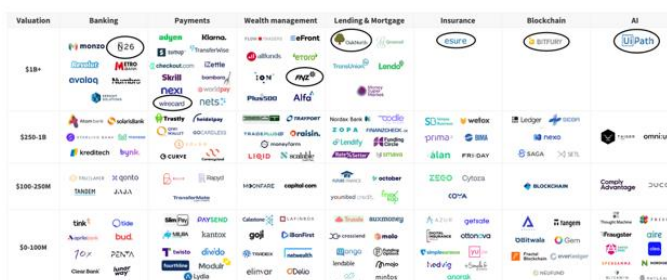


Figure 10 – Source: Finch Capital & Dealroom.co, 2019⁶¹

More in detail if we analyze the Fintech payments market (Figure 11) we can see that Wirecard occupies a dominant position among European Fintech companies with its valuation of over \$10 billion (in fact at the peak of its value it was valued at \$24 billion).

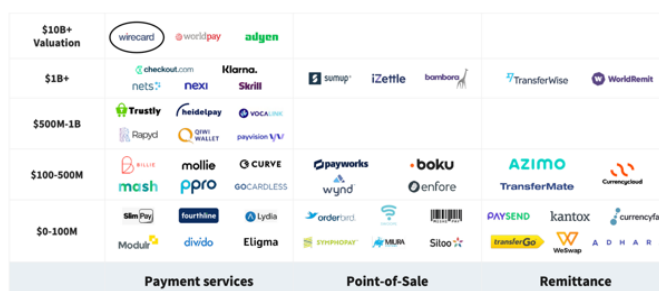


Figure 11 – Source: Finch Capital & Dealroom.co, 2019⁶²

According to an analysis conducted by the European Banking Authority (EBA), the regulation of these firms varies considerably. This analysis was conducted by the EBA to assess the level of legislative harmonization between different member countries regarding fintech companies offering digital banking services. For example, 18% are payment institutions that are regulated by the current payment’s directive, PSD II (Payment Services Directive II), and 11% are investment firms under MiFID II (Markets in Financial Instruments Directive II). However, 31% are not subject to any EU or national regulation and 14% are subject only to national legislation⁶³.

In particular, of the 31% of fintech companies that are not subject to regulation, the EBA estimates that 33% provide payment services, 20% credit, deposits and capital raising, while 11% provide investment services or

⁶¹ Finch Capital & Dealroom.co (2019). The State of European Fintech.

⁶² Finch Capital & Dealroom.co (2019). The State of European Fintech.

⁶³ Alvarez C. (2017). Fintech map of Europe: 31% of the companies, unregulated. BBVA.

investment management⁶⁴. At this stage, it is important to point out to the reader that Wirecard was supervised directly by FREP and in eventual cases by BaFin as it was considered a fintech company and not a banking institution, although it could issue credit and debit cards. This classification of Wirecard is due to the fact that banking services were not the core business of the Wirecard group, it remained in fact the processing of payments. The banking activities were all carried out by Wirecard's banking arm, Wirecard Bank AG, thus ensuring that the consolidated group was not recognised as a banking institution⁶⁵.

The technological innovation that characterizes this sector makes it increasingly difficult for the competent authorities to keep up with their effective regulation, the continuous innovation makes it possible for Fintech companies to always remain in the regulatory shadow, that part of the market that is difficult to characterize and therefore difficult to supervise. The increasing opacity of Fintech companies also through the use of increasingly complex systems, such as the exploitation of blockchain and other emerging technologies makes the work of regulators increasingly difficult and puts them in front of a challenge to protect investors and consumers. To avoid the risks that this lack of regulation could pose for consumers, the European Commission has developed and introduced two regulations that have a major impact on financial technology: the PSD II (Payment Services Directive) which regulates the payments industry, and consumer data protection through the GDPR (General Data Protection Regulation)⁶⁶.

A secure regulatory environment can be a factor in fostering a competitive fintech sector in Europe, which is one of the EU's priorities. In fact, the ever-increasing complexity of the technologies governing digital finance made it necessary for the European Commission to intervene and adopt the Digital Finance Package (DFP) in 2020. The DFP is a set of rules and strategic decisions aimed at improving the quality of digital financial services offered in Europe and stimulating their use, while at the same time offering greater protection to consumers of these services, supporting digital transformation⁶⁷. Digital finance refers to any financial service provided to the consumer through mobile phones, personal computers, the internet, or cards linked to a reliable digital payment system, it has the potential to provide an accessible, convenient and secure banking service⁶⁸. The Digital Finance Package proposes some innovations in the field of digital finance regulation.

The first key proposal contained in the DFP is the proposed **pilot regime**, a sort of 'sandbox regime', designed to allow regulated institutions to develop Distributed Ledger Technology (DLT)-based infrastructures for the

⁶⁴ Alvarez C. (2017). Fintech map of Europe: 31% of the companies, unregulated. *BBVA*.

⁶⁵ Garciaosma B., Gisbert A., and Navallas B. (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

⁶⁶ Alvarez C. (2017). Fintech map of Europe: 31% of the companies, unregulated. *BBVA*.

⁶⁷ European Commission official website (2020). Search for “*Digital finance package*”.

⁶⁸ Durai T., and Stella G. (2019). Digital finance and its impact on financial inclusion. *Journal of Emerging Technologies and Innovative Research*, 6(1), 122-127.

trading, custody, and settlement of securities by benefiting from temporary exemptions from certain regulatory requirements. This 'sandbox regime' was deemed necessary because DLT and financial instruments in the form of crypto assets are at an embryonic stage of their development and therefore difficult to recognize⁶⁹.

The second proposal is the **MiCAR** (Markets in Crypto-Assets Regulation) proposal, which aims to capture crypto-assets that do not qualify as financial instruments. MiCAR establishes minimum disclosure requirements on the issuance and admission to trading of crypto assets for issuers wishing to offer them to the public⁷⁰.

Finally, the DFP's last proposal is the **DORA** (Digital Operational Resilience Act) proposal, which aims to ensure that all participants in the financial system have the necessary safeguards in place to mitigate cyber-attacks and other risks. All companies will be required to ensure that they can withstand any kind of disruption and threats related to Information Communication Technologies (ICT)⁷¹.

The DFP also contains the Digital Finance Strategy, which sets out how Europe and its member states can best support the digital transformation of finance in the coming years, while mitigating risks. This strategy sets key objectives such as removing or at least reducing the fragmentation of the European digital single market or facilitating digital innovation by adapting the EU regulatory framework to new technologies⁷². The rather low pace of financial supervisors' digital transformation and the fast growth in technology leads to an increase in the technological gaps between supervisors and their regions of responsibility and produce a new phenomenon named "*asymmetric technology*"⁷³. It is indeed crucial that the European regulatory framework innovates as well as the surrounding environment. As digital finance accelerates and facilitates cross-border transactions, it also has the potential to enhance financial market integration in the banking union and capital markets union and could thus strengthen Europe's economic and monetary union⁷⁴.

The inadequacy of regulatory frameworks to react to the rapid innovation of the fintech market generates regulatory fragmentation and regulatory friction, leading to a disincentive for cross-border transactions between different EU member states⁷⁵.

⁶⁹ European Commission official website (2020). Search for "*Digital finance package*".

⁷⁰ European Commission official website (2020). Search for "*Digital finance package*".

⁷¹ European Commission official website (2020). Search for "*Digital finance package*".

⁷² European Commission official website (2020). Search for "*Digital finance package*".

⁷³ Zeranski, S., & Sancak, I. E. (2020). Does the 'Wirecard AG' Case Address FinTech Crises?

⁷⁴ European Commission official website (2020). Search for "*Digital finance package*".

⁷⁵ Ahern, D. M. (2021). Regulatory Lag, Regulatory Friction and Regulatory Transition as FinTech Disenablers: Calibrating an EU Response to the Regulatory Sandbox Phenomenon. *European Banking Institute Working Paper Series 2021 - no. 102*.

3.2 Wirecard's business model - How did Wirecard generate profits? And how do the Third-Party Acquirers (TPAs) work?

I will now analyze Wirecard's business model and show what its main sources of income were. Although the business model adopted by Wirecard has always remained opaque and unclear, it is possible to say that Wirecard was a company that provided payment services (Payment Services Provider) which therefore made its revenue by allowing merchants to accept electronic payments (e.g., through debit cards, credit cards and contactless payments via smartphones) and then processing the transactions underlying those payments⁷⁶. A payment provider company is an organization that facilitates financial transactions, between those who sell something and those who have to buy it – often sitting behind the scenes when you use a credit card or move money between bank accounts there is a payment provider company that guarantees the execution of that transaction – and which earns money through commissions paid by those involved in the transaction. Despite the smokescreen surrounding Wirecard's business, most people did not seem to mind this lack of clarity – after all, despite its central role in the economy, the fintech industry is characterized by a remarkably high degree of opacity in general. In fact, it is conceivable that most people attributed the lack of clarity in Wirecard's financial statements to the complexity of the fintech market and not, as it turned out to be, to the presence of misleading and fraudulent data.

in EUR million	30 Sept 2019	31 Dec 2018
Payment Processing & Risk Management	568.6	552.6
Acquiring & Issuing	157.0	153.0
Call Center & Communication Services	0.3	0.3
Total	725.9	705.9
Less: impairment losses	0.0	0.0
	725.9	705.9

Figure 12 – Source: Wirecard, 2019⁷⁷

Looking at Wirecard's reported financial statements for fiscal year 2019, it can be observed that Wirecard's earnings came mainly from three different sources. The least impactful activity for Wirecard's profits is the one called "Call Center & Communication Services", the income from these activities is actually negligible as it is close to zero.

The second highest level of participation in the generation of Wirecard's profits is occupied by the activity that is reported in the financial statements as "Acquiring & Issuing". This activity consists of issuing credit

⁷⁶ Bradley H. K. (2021). Wirecard: When Fintech goes rogue.

⁷⁷ Wirecard official website (2019). Search for "Q3 statement Q3 financial report 2019".

cards and prepaid cards to customers, but this activity accounts for just under half of the profits reported in the 2019 financial statements.

The third and final business segment reported by Wirecard in its financial statements, the one that generates most of its profits, in fact, it weighs more than half of the total reported profits, is called "*Payment Processing & Risk Management*". This segment consists of all the products and services offered by Wirecard that relate to the processing and acceptance of transactions and payments.

Transaction Volume 9M 2019 / 9M 2018

in EUR billion	9M 2019	9M 2018	Change in percent
Europa	58.6	45.2	29.8%
Out of Europe	65.5	45.0	45.5%
Total	124.2	90.2	37.7%

Figure 13 – Source: Wirecard, 2019⁷⁸

Still referring to Wirecard's official 2019 financial report, we can see that the portion of profits generated outside of Europe is increasing and in fact, in the years between 2017 and 2019, the company has increasingly increased its investments outside of Europe and more precisely in Asia, so much so that the Asian continent has become the most profitable geographical market for the payment provider company. This incredible number of profits generated in Asia, would then, a few months later, turn out to be actually false and deceptive, generated through a complex scheme of fraudulent transactions carried out with the help of its third-party acquirers in Asia.

But speaking of TPAs, what was Wirecard's business model and how did it work?

Wirecard is a payment processing company that provides other companies with the equipment and services necessary to be able to accept online payments, but how did Wirecard generate its profits?

When a client buys a product or service from a merchant by means of a virtual payment, the bank of the customer transfers the money to the acquirer – in our case the acquirer is Wirecard and the banks are the issuers of the cards used by Wirecard's clients i.e., Visa, Mastercard and JCB – who will then transfer the money to the merchant from which the customer originally purchased the product or service⁷⁹. Wirecard as acquirer protects credit card companies, for example, from the risk that the merchant does not actually provide the product or service to the customer or other such cases. To protect itself against this risk, the acquirer defers payments for a longer or shorter period of time, the length of this delay being decided after

⁷⁸ Wirecard official website (2019). Search for "*Q3 statement Q3 financial report 2019*".

⁷⁹ Meitner V. M. (2020). Wirecard: Wirecard's Thrilla in Manila: The Story so far. *Valuesque*.

an assessment of the risk profile of the merchant involved in the transaction. In any case, the acquirer retains parts of the transaction sum as additional collateral. This scheme is shown in the flow chart in the figure below (Figure 14).

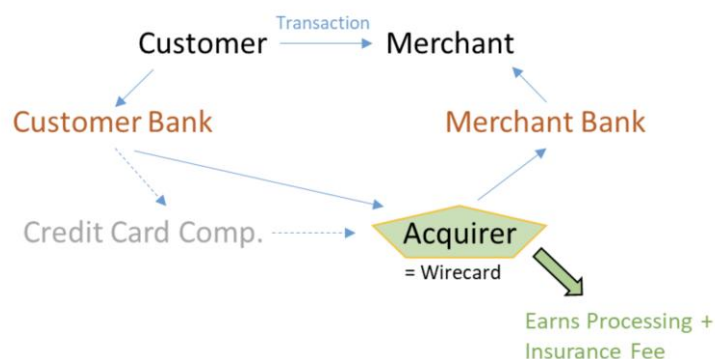


Figure 14 – Source: Meitner, 2020⁸⁰

In order to process these payments, each acquirer must have a banking licence in each region where it wishes to do so. For example, in Europe Wirecard had a banking licence through its subsidiary Wirecard Bank AG, which was authorised by Visa, Mastercard and JCB.

In order to be able to offer such services worldwide, however, it would be necessary to have a banking licence in each different region of the world. This is obviously impractical for Wirecard. In order to circumvent this problem, Wirecard, like other payment companies, makes use of Third-Party Acquirers. TPAs are companies that make available to another company – from which the name third party acquirers derive – without such a banking licence, the right to use their licence in a certain country, against payment of fees for transactions carried out in this way. The figure below (Figure 15) shows the flow chart of the functioning of the previous model with the presence of a TPA.

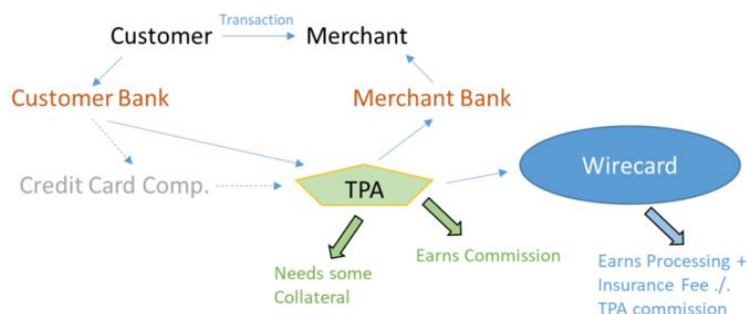


Figure 15 – Source: Meitner, 2020⁸¹

⁸⁰ Meitner V. M. (2020). Wirecard: Wirecard’s Thrilla in Manila: The Story so far. *Valuesque*.

⁸¹ Meitner V. M. (2020). Wirecard: Wirecard’s Thrilla in Manila: The Story so far. *Valuesque*.

The acquirer, in order to protect the TPA from possible risks arising from the transaction between the customer and the seller, is obliged to set up escrow accounts, so as to have the necessary reserves to mitigate such risks. The reader will understand in the next chapter the fundamental importance of these escrow accounts in the Wirecard affair. In fact, it is these accounts that will become the focus of the scandal when, on 18 June 2020, it is discovered that two of them never existed, while there was thought to be around €1.9 billion. The escrow accounts in question contained so many reserves because they were the ones used to protect the three main TPAs Wirecard used. These TPAs, Senjo, PayEasy and Al Alam in 2016 were found to have contributed around 95% of Wirecard's EBITDA and more than 50% of its revenues⁸². As can be seen from the figure below (Figure 16) in fact over 50% of the sales made by the Wirecard group in 2016 were attributable to these three TPAs.



Figure 16 – Source: McCrum, 2019⁸³

⁸² McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

⁸³ McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

4. Wirecard, history of a European financial debacle

In this third chapter I will bring the reader into the heart of the history by analyzing in detail the events and actions that led Wirecard to bankruptcy. In the first paragraph I will report on all the events that have characterized the history of Wirecard, from its foundation in 1999 to the present. Subsequently, I will provide a description of these events, focusing on the most important ones for the development of the story. I will also comment on the various attacks that Wirecard has received over the years, which could have set off a bell by stopping the fraud and limiting the damage.

After that, in the following paragraphs, I will analyse what were the critical aspects of Wirecard's supervision. I will try to examine what were the events and behaviors that made a scandal of this magnitude possible. This analysis will start from what seems to have been the critical point of the story: the failure of the flow of information. In fact, after looking at the events that characterize the history of Wirecard, it is clear that something went wrong with the flow of information. Several times over the years, the company has been at the center of accusations of fraud and money laundering by an important and reliable newspaper such as the Financial Times or by groups of short sellers who through their transactions express their opinion about a company, thus providing information to the market. Each time, however, this flow of information has gone unheeded by the competent authorities or, in the worst cases, triggered investigations against the authors, as in the case of the FT journalists or the Zatarra short sellers.

After the analysis of this crucial point, I will shift my attention to the internal control system of Wirecard and its Supervisory Board, which were unable to identify and prevent the fraud. Subsequently I will examine the criticalities found in the external audit, in fact, not even Ernst & Young, Wirecard's auditing company, was able to identify and prevent the fraud. EY was Wirecard's auditing firm for over 10 years and never noticed the fraud despite the various alarm bells ringing, I remind the reader that EY was hired in 2008 precisely to respond to the first allegation of financial statement irregularities.

Finally, I will conclude this chapter by analyzing the weaknesses of the national supervisory system that should have ultimately ascertained the correctness of Wirecard's accounts. These bodies should have ensured the proper functioning of the markets but repeatedly failed to identify any irregularities.

4.1 What happened? From rumors to bankruptcy, timeline of the story and summary of main events

1999

Wirecard was founded in Aschheim, a small town near Munich. A payment processor, aiming to help websites collect credit card payments from customers. Founded with the intention of becoming the German “PayPal” and competing within the global fintech market.

2002

Markus Braun, a former KPMG consultant, took over as Chief Executive Officer and merged Wirecard with a Munich-based rival, Electronic Business Systems.

2005

Wirecard is listed on the Frankfurt Stock Exchange (Deutsche Boerse Frankfurt) through the takeover of a defunct call center group (InfoGenie AG), thereby avoiding the normal scrutiny expected of an Initial Public Offering. The core business is the processing of payments for pornography and gambling websites.

2006

Wirecard acquires XCOM Bank AG, a banking service provider based in Dreieich, offering online transactions, direct banking and other related banking services. Renamed Wirecard Bank AG, a company with a German banking license. It can issue credit cards since it is authorized by Mastercard, Visa and JCB (Japan Credit Bureau), it can also handle money on behalf of merchants through the TPA business model seen above. This mix of non-banking (Wirecard) and banking (Wirecard Bank AG) operations makes its accounts opaquer and more difficult to compare with similar businesses. Since Wirecard's core business was not banking, the group was not identified as a banking institution and therefore did not fall under the direct supervision of BaFin.

2007

Wirecard expands its horizons by establishing Wirecard Asia Pacific. Asia will become the epicenter of its business, the scene of the Wirecard scandal.

2008

The first attack: a small shareholders' association – SdK (Schutzgemeinschaft Der Kleinaktionäre) – accuses Wirecard of accounting customers' deposits as its own money and of other balance sheet irregularities. The

consulting firm Ernst & Young (EY) is hired to carry out a special audit of the 2007 financial statements and from then on EY becomes the auditor of the Wirecard Group.

2010

Wirecard elect Jan Marsalek as Chief Operating Officer. Given Wirecard's global aims, the company will begin operating by adopting English as its primary language and announces that it will plan an international expansion.

From 2011 to 2014

Wirecard makes numerous purchases thanks to the collection of several million euros from shareholders. It acquires various payment companies in Asia through a series of suspiciously structured deals and transactions. Its headquarters in the region becomes Singapore. Its rapid and powerful growth continues to attract more and more investors.

2015

The Financial Times (FT) starts its own article series "House of Wirecard", accusing Wirecard of discrepancies in its group's balance sheet⁸⁴. The FT argues that there might be 250 million of euros missing from the group's balance sheet. Wirecard responded, through a UK law firm, that these inconsistencies are due to variation into accounting standards between a country and another. In October, of the same year, Wirecard acquires an Indian payments business, its biggest purchase (€340 million).

2016

A group of anonymous short sellers under the pseudonym "Zatarra" published a report accusing Wirecard's senior executives of money laundering, fraud, and corruption⁸⁵. Wirecard denies every allegation and BaFin starts an investigation against Zatarra group and others for alleged market manipulation. In the same year Wirecard acquired a prepaid payment card business from Citigroup, thus entering the North American market.

2017

After an unblemished audit by EY and a visible improvement in cash generation have renewed investor enthusiasm for Wirecard, so much so that its share price has risen more than 100%. The group announced

⁸⁴ McCrum D. (2015). The House of Wirecard.

⁸⁵ Zatarra (2016). Zatarra report. *Zatarra Research & Investigation*.

an agreement to take over Citi's payment processing operations in 11 countries in Asia, a transaction designed to make Wirecard a leading name in the region.

2018

- **March 2018** – In Singapore, which is Wirecard's headquarters in Asia, an internal investigation is being launched by the group's legal staff. This investigation began following a complaint by a Whistleblower who reported possible irregularities. Apparently, a plan was underway, orchestrated by members of the finance team, to irregularly send money to India through third party companies in a practice known as "Round Tripping".
- **August 2018** – Wirecard's shares hit a peak of €191 per share, taking Wirecard's valuation to over €24 billion⁸⁶. The group claims to have 5,000 employees and processes payments for more than 250,000 merchants, including nearly 100 airlines and the famous German discounters Lidl and Aldi. Wirecard issues credit and prepaid cards to its customers and provides the technology needed to make contactless payments via smartphones.
- **September 2018** – Wirecard enters the renowned DAX 30 index by right, replacing Commerzbank, making it officially one of the 30 most valuable German companies listed on the Frankfurt Stock Exchange⁸⁷. Through its entry into the DAX blue-chip market index, Wirecard becomes an automatic investment for pension funds worldwide, thus effectively increasing its ability to raise capital. Thanks to this valuation, it becomes Europe's largest fintech, the only one able to compete with its huge Silicon Valley rivals (such as PayPal or Stripe).
- **October 2018** – Whistleblowers write to the Financial Times convinced that the internal investigation, which began a few months earlier (March 2018), has been silenced, without making the outcome of the investigation public, as if to cover up the suspicious movements of the finance team.

2019

- **30 January 2019** – Approximately 10 months after the start of the Singapore investigation (March 2018), the Financial Times publishes its first article on the topic, in which the Wirecard Group is accused of increasing revenues through the use of backdated and falsified contracts⁸⁸. Wirecard immediately responded by calling the article false and defamatory. BaFin also intervened and initiated an investigation into the Financial Times and the authors of the article on charges of market manipulation.

⁸⁶ McCrum D. (2020). Wirecard: the timeline. *Financial Times*.

⁸⁷ Reuters staff (2018). Germany's Commerzbank gets the boot from the DAX index. *Reuters*.

⁸⁸ McCrum D., and Palma S. (2019). Executive at Wirecard suspected of using forged contracts. *Financial Times*.

- **15 – 19 February 2019** – Singapore law enforcement officers search Wirecard's headquarters. BaFin instructs FREP to begin an examination of Wirecard's accounts as at 30 June 2018. Recall that the FREP is not tasked with conducting investigations in search of accounting fraud. The FREP is only tasked with verifying that the financial statements comply with accounting standards. Wirecard's share price collapses below €100 and BaFin decides to ban short selling for two months, to safeguard economic stability given the importance of the company involved⁸⁹. ESMA also commented on the decision, stating: "*The current circumstances related to Wirecard are adverse events or developments which constitute a serious threat to market confidence in Germany, and that the proposed measure is appropriate and proportionate to address the threat to German financial markets*"⁹⁰.
- **28 March 2019** – The Financial Times publishes a report in which Wirecard's business model is brought to light⁹¹. The report claims that Wirecard has its payments processed by third-party companies that then pay Wirecard commissions, thus effectively outsourcing about half of its business. The Financial Times then also attempted to visit one of these third-party companies in the Philippines. Instead, however, the FT found the home of local fishermen, who knew nothing about the third-party company it was looking for. In response, Wirecard sued the Financial Times, accusing it of using company secrets and misrepresenting them⁹².
- **15 April 2019** – The Financial Times publishes a new article accusing Wirecard of falsifying the sales and profit numbers reported in the Dublin and Dubai units and claiming that many of the customers featured in the documents submitted by EY do not actually exist. In support of these allegations The Financial Times also publishes internal documents. Wirecard professes his innocence and claims that the documents presented by the Financial Times are not authentic.
- **24 April 2019** – The Financial Times publishes a new article in which it emerges that most of the Wirecard Group's global profits are attributable to three third-party companies based in Singapore, Dubai, and the Philippines⁹³. BaFin charges two Financial Times journalists, Stefania Palma and Dan McCrum, and ten short sellers on suspicion of market manipulation.
- **31 October 2019** – To refute the allegations published by the journals, Wirecard instructs KPMG to conduct an independent special audit of its accounts and claims that such a report will cleanse itself of all wrongdoing.
- **9 December 2019** – The Financial Times publishes a new report in which it accuses Wirecard of fraudulently overstating its reported cash reserves in 2017 by including within them money held in

⁸⁹ BaFin official website (2019). Search for "*Wirecard AG: General Administrative Act on the prohibition on establishing and increasing of net short positions*".

⁹⁰ ESMA official website (2019). Search for "*ESMA issues positive opinion on short selling ban by BaFin*".

⁹¹ McCrum D., and Palma S. (2019). Wirecard's problem partners. *Financial Times*.

⁹² Reuters staff (2019). Wirecard sues FT over investigative reports. *Reuters*.

⁹³ McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

escrow accounts used by third parties in its payment processing operations⁹⁴. Wirecard defends itself by saying that the money within the escrow accounts is considered cash equivalent and the details are in the audit report.

2020

- **12 March 2020** – Wirecard states that the investigation conducted by KPMG is nearing completion and so far, the auditing firm has reported no evidence that the financial statements had been forged or manipulated. The end of the audit, however, is postponed until April due to the publication of a report by Ernst & Young, Wirecard's auditing firm. In the report, EY claims to have received documents from a trustee located in the Philippines regarding two accounts containing €1.9 billion at two different banks in the country.
- **22 April 2020** – Wirecard suspiciously releases another statement regarding KPMG's special audit, reiterating that it is not yet finished, but so far KPMG has not been able to prove any balance sheet manipulation⁹⁵.
- **27 April 2020** – KPMG finally concludes its special audit and publishes the report containing its findings⁹⁶. The report shows that the auditor is unable to locate about a quarter of the balance sheet (€1bn), which is supposed to be held in escrow accounts, due to the poor cooperation of Wirecard and its third-party acquirers (TPA), who are unable to provide sufficient documentation. According to KPMG, Wirecard increased profits and sales by manipulating financial statements (a technique known as Round Tripping). Wirecard Bank AG apparently sent its money to an opaque network of "external customers" and subsidiaries de facto simulating lawful profits. The profits generated in this way through the TPAs are, according to Wirecard, held in escrow accounts at two banks in the Philippines. However, the banks in question deny that Wirecard has ever been a customer and the Philippine authorities claim that there has never been any transaction of the money from Wirecard to the Philippines. Markus Braun immediately denies any wrongdoing and to reassure investors makes a statement claiming that: "E&Y informed us this morning that they have no problem signing off on the 2019 audit"⁹⁷. However, the publication of the audit is postponed until May, a delay due, according to Wirecard, to the outbreak of the COVID-19 pandemic.
- **30 April 2020** – After the publication of the results of the special audit conducted by KPMG, BaFin instructs FREP to examine Wirecard's accounts as of 31 December 2018 as part of the two-stage

⁹⁴ McCrum D. (2019). Wirecard's singular approach to counting cash. *Financial Times*.

⁹⁵ Wirecard official website (2020). Search for "*Wirecard AG: KPMG special review lasts until April 27, 2020. Analysis so far provides no evidence of balance sheet manipulation*".

⁹⁶ KPMG staff (2020). Report concerning the independent special investigation. *KPMG*.

⁹⁷ Bloomberg (2020). Yahoo Finance: Wirecard's auditors EY say they were victims of an 'elaborate' fraud by their client that ended in US\$2 billion of missing funds.

procedure. As a reminder, FREP had already been instructed to examine the accounts as of 30 June 2018 and this assignment has not yet been completed.

- **25 May 2020** – Ernst & Young delays for the third and final time the publication of 2019 audit results.
- **2 June 2020** – Following Wirecard's repeated misleading ad-hoc statements about the KPMG special audit and its status, BaFin has decided to criminally sue the company.
- **5 June 2020** – Following Wirecard's complaint by BaFin, Munich prosecutors initiated a criminal investigation against three members of Wirecard's executive board and the CEO, Markus Braun, and ordered a search of the giant fintech offices.
- **16 June 2020** – BPI (Bank of the Philippine Island) and BDO (Banco de Oro), the banks where Wirecard claims to hold approximately €1.9 bn, inform Ernst & Young that the documents in its possession that are supposed to place this money in the two banks are forged.
- **18 June 2020** – Wirecard is unable to publish audited results for 2019 since Ernst & Young, the company that is supposed to certify them, refuses to sign off on the 2019 financial statements as it was unable to verify the existence of €1.9 billion, held in escrow accounts at the two Philippine banks. EY states that there are “clear indications for a [...] sophisticated fraud involving multiple parties around the world in different institutions with a deliberate aim of deception”⁹⁸. Subsequently, BaFin issues a criminal complaint against Wirecard for accounting fraud and subsequent market manipulation through the publication of fraudulent financial statements during the period from 2016 to 2018. The Chief Operating Officer Jan Marsalek is suspended, and James Freies takes his place.
- **19 June 2020** – After only 1 day on the job James Freies becomes Wirecard's interim CEO, following the resignation of Markus Braun. The payments company meanwhile is busy trying to stay afloat and reassure the banks that finance it.
- **22 June 2020** – The Board of Directors of Wirecard finally drops the mask and admits that there is a very high likelihood that the €1.9 billion previously reported in the financial statements never actually existed.
- **23 June 2020** – Markus Braun, the former CEO of Wirecard is arrested on charges of fraudulently falsifying the company's accounts in order to manipulate the market. He will be released the same day on bail.
- **24 June 2020** – FREP is instructed by BaFin to examine Wirecard's accounts as at 30 June 2019.
- **25 June 2020** – After the multi-billion-dollar hole in its books was discovered, Wirecard is forced to file for bankruptcy, owing its creditors over €3 billion and given its imminent and inevitable

⁹⁸ Reuters staff (2020). Auditor EY says clear indications of fraud at Wirecard. *Reuters*.

insolvency. The FREP is also commissioned by BaFin to examine Wirecard's accounts as of 31 December 2017.

- **26 June 2020** – The Financial Times accuses Ernst & Young of being too superficial⁹⁹. The auditors relied only on screenshots and documents provided by a trustee to confirm that the lender actually held €1 billion and did not check directly with one of Asia's largest banks, the OCBC (Oversea-Chinese Banking Corporation) Bank in Singapore.
- **28 June 2020** – The Federal Ministry of Justice and the Federal Ministry of Finance announce that the contract with FREP has a remaining term of 18 months and that it will, however, be duly ended.
- **2 July 2020** – Felix Hufeld, the head of BaFin, the German financial supervisory authority, has issued a statement calling the Wirecard financial debacle “a massive criminal act”.
- **6 July 2020** – The head of a Dubai-based Wirecard subsidiary is arrested by German prosecutors.
- **9 July 2020** – Money laundering is added to the numerous charges brought by German prosecutors against Wirecard.
- **16 July 2020** – The head of Wirecard's Dubai-based subsidiary, 10 days after his arrest, relents and admits his participation in a multi-billion-euro fraud perpetrated over several years.
- **20 July 2020** – BaFin receives notice from FREP that Wirecard has rejected the results of the examination of the accounts as of 30 June 2018 and 31 December 2018 and also refuses to cooperate in respect of the accounts as of 31 December 2017 and 30 June 2019. It is only after this communication that BaFin can intervene, fulfilling its duties in the 2-step procedure.
- **22 July 2020** – Markus Braun is again arrested along with two others former Wirecard executives by German prosecutors on charges of organizing a criminal racket to manipulate the company's accounts and fraudulently defraud creditors and investors of billions of euros.
- **4 August 2020** – The examination of Wirecard's accounts by BaFin formally begins through publication in the official gazette.
- **1 September 2020** – A parliamentary enquiry into Wirecard has been launched in order to clarify a story that is far from clear.

2021

- **24 January 2021** – Edgar Ernst, the head of the German accounting supervisory authority FREP, who has come under criticism for failing to detect the wrongdoings that led to the bankruptcy of Wirecard, Germany's and Europe's largest payment processing company, is stepping down.
- **29 January 2021** – Felix Hufeld, now former president of BaFin, announces his resignation.

⁹⁹ Storbeck O., Kinder T., and Palma S. (2020). EY failed to check Wirecard bank statements for 3 years. Financial Times.

- **3 February 2021** – Olaf Scholz, Germany’s Vice-Chancellor and Minister of Finance, announces that he is giving BaFin more powers to make it more agile and better able to identify and investigate any misconduct committed by the companies it supervises¹⁰⁰.
- **22 and 23 April 2021** – Olaf Scholz and Angela Merkel have testified before the Bundestag enquiry committee on the Wirecard case to clarify their role in the scandal. Both rule out any responsibility of the German government in the events leading up to the Wirecard scandal¹⁰¹.

After this list of events characterizing the history of Wirecard, I will now provide the reader with a detailed analysis of them, taking a deep dive into the most important ones and analyzing which ones were crucial for the development of the scandal.

Wirecard, the German fintech payments provider was founded in 1999, in Aschheim, a city near Munich. A few years later, in 2002, a former KPMG executive, Markus Braun, became its CEO and set Wirecard on the path to becoming Europe's largest fintech company.

In 2005, Wirecard was listed in the Prime Standard of the Deutsche Börse through the acquisition of InfoGenie AG, an almost dead call center company listed in this segment. This method of listing, the reverse IPO, avoids the classical checks that companies have to undergo when being admitted to market segments. In 2006, Wirecard expanded acquired XCOM Bank AG in order to be able to compete in the banking services market as well and obtained authorization to issue credit cards from both Mastercard and Visa. At this stage, it is important to point out to the reader that the Wirecard group, through the establishment of its banking branch, is able to offer all related banking services but is not classified as a banking institution as its core business remains the provision of technology. As a result of this classification, Wirecard does not fall under the direct supervision of BaFin, which is foreseen for banks, but will instead be subject to the two-tier financial reporting enforcement procedure, which is carried out by FREP and BaFin in cooperation.

The following year, in 2007, Wirecard expanded its horizons and founded its Wirecard Asia Pacific division and set up its headquarters in Singapore.

In 2008, Wirecard suffered its first "attack", in fact, a small German shareholder association, the SdK, accused Wirecard of various accounting irregularities. Wirecard is accused, among other things, of accounting for money held in customer accounts as equity of the company. In order to defend itself, Wirecard hires Ernst & Young to audit its financial statements. EY will remain Wirecard's auditing firm from now on. Seven years after the first attack on Wirecard, during which the payment provider company made several suspicious acquisitions in Asia of other payment processors, the British newspaper Financial Times publishes the first article in the long series called "House of Wirecard".

¹⁰⁰ Federal Ministry of Finance official website (2021). Search for: “More “bite” for the Financial Supervisory Authority”.

¹⁰¹ O’Donnel J., and Kraemer C. (2021). Germany's finance minister rejects blame for Wirecard fiasco. *Reuters*.

In 2015 article, the FT accuses the German fintech of numerous inconsistencies in the books of the Wirecard group, according to the British newspaper in fact in the consolidated financial statements are reported around 250 million euros that may be missing. Wirecard justifies itself by claiming that the inconsistencies are only due to differences in accounting standards between the various countries in which it operates.

The following year, in 2016, an anonymous group of short sellers, known as Zatarra, published a report in which Wirecard was accused of fraud, corruption and money laundry. Following the publication of this report Wirecard's shares experienced a significant increase in short selling. The group's board of directors immediately denied any accusations. For the first time, we see the intervention of the German market supervisor, BaFin, which, following the publication of the report, opens a file against the short sellers on the charge of market manipulation. The report published by Zatarra consists of about 100 pages, a lot of documentation for an attempt at market manipulation, since rumors are sufficient to influence prices¹⁰². The question therefore arises as to whether BaFin has given the report due consideration, or whether, given the foreign origin of the attack, it has been regarded as an attempt to undermine the success story of the German jewel Wirecard.

In September 2018, after Wirecard's shares hit their high of €191 per share, and the company reached its maximum valuation at €24 billion, the stock was admitted to trading in Germany's most important index, the one that includes Germany's 30 most highly capitalized companies, the DAX30, replacing the German bank Commerzbank.

In January 2019, the Financial Times published an article about the Singapore investigations that had begun a few months earlier in which the Group was accused of increasing profits through the use of fake or backdated contracts. BaFin responds to this umpteenth accusation by making an accusation against the authors of the article on charges of market manipulation. In February of the same year, following a search of the Singapore offices, BaFin fulfils its task in two-tier enforcement procedure by instructing FREP to examine Wirecard's financial statements as of 30 June 2018. It is important to remember that FREP's task is to check that the financial statements meet accounting standards, not to look for accounting fraud. The same month, BaFin, after the value of the shares fell by almost 50%, with the approval of ESMA which expressed its positive opinion, issued a short-selling ban to safeguard economic stability. In April 2019, the Financial Times articles continue and in a new one, the Wirecard group, is accused of falsifying reported profits and it is claimed that the customers reported in the documents reported by EY are in fact fictitious. Six months later, in October 2019, trying to reassure the market and investors about the company's health, Wirecard commissioned KPMG to conduct a special audit of its financial statements, claiming that the results of such an extraordinary audit would dispel any doubts about the group's innocence. Just two months later, in December 2019, Wirecard was again featured in an article in the FT accusing it of increasing its cash reserves

¹⁰² Zatarra (2016). Zatarra report. *Zatarra Research & Investigation*.

reported in 2017, through the inclusion in those reserves of money held in escrow accounts used by TPAs while conducting its business abroad¹⁰³. Wirecard responds by arguing that the money held in the escrow accounts in question is properly considered cash equivalent: *“Trust accounts are only used to segregate our own cash from the operating cash of partner acquirers. Such trust accounts are held in the name of Wirecard, and the funds can be accessed at any time”*¹⁰⁴.

In March 2020, Wirecard began making statements regarding the forensic audit conducted by KPMG, stating that the investigation was nearing completion and that no irregularities had been found by the auditing firm to date. The following month, Wirecard published another statement reiterating that the investigations, which have found no irregularities to date, are nearing their conclusion. This move aroused a lot of suspicion on the part of the authorities who, as I will report shortly, will take action on the matter.

A few days later, however, on 27 April 2020, KPMG published the report containing the results of its special investigation. In the report, the auditing firm claims that, due to the lack of cooperation from the TPAs working with Wirecard, it is unable to confirm the existence of €1 billion supposedly contained in escrow accounts at two Philippine banks. In the words of KPMG: "With regard to the amount and existence of sales revenues from the TPA business relationships between Cardsystems Middle East, Wirecard UK & Ireland as well as Wirecard Technologies and the respective relevant TPA partners, KPMG cannot make any statement as a result of the forensic investigation activities carried out with regard to the investigation period 2016 to 2018 that the sales revenues exist and are correct in terms of their amount, nor can it make any statement that the sales revenues do not exist and are incorrect in terms of their amount"¹⁰⁵. The report reveals that the two Philippine banks in question, BPI (Bank of the Philippine Island) and BDO (Banco de Oro), claim that Wirecard has never been their customer. The group's CEO, Markus Braun, is quick to deny any allegations of mismanagement and to reassure investors he says Ernst & Young will have no problem signing off shortly on the 2019 audit. However, the result of the audit is postponed again, due to problems, according to Wirecard, caused by the COVID-19 pandemic that broke out a few months earlier.

After the publication of the results of the special audit conducted by KPMG, BaFin instructs FREP to examine the group's financial statements as of 31 December 2018. A little over a month later, in June 2019, as I had anticipated earlier, the BaFin decides to criminally prosecute for suspected market manipulation Wirecard for the misleading and ad hoc statements made about the status of the special audit by KPMG.

Three days later, Munich prosecutors initiated a criminal investigation against three members of Wirecard's executive board and the CEO, Markus Braun, and ordered a search of the giant fintech offices. On 16 June 2020, the two Philippine banks, BPI and BDO, informed Ernst & Young that the documents held by the

¹⁰³ McCrum D. (2019). Wirecard's singular approach to counting cash. *Financial Times*.

¹⁰⁴ McCrum D. (2019). Wirecard's singular approach to counting cash. *Financial Times*.

¹⁰⁵ KPMG staff (2020). Report concerning the independent special investigation. *KPMG*.

auditors, which were supposed to have placed around EUR 2 billion in escrow accounts held by them, were in fact forgeries. The two banks also repeat to EY that Wirecard was never their client.

On 18 June 2020, EY refuses to sign off on Wirecard's 2019 financial statements, as it was unable to verify the existence of EUR 1.9 billion held in escrow accounts at the 2 Philippine banks. After EY's refusal, since Wirecard was not able to publish its audited accounting reports, BaFin issues a criminal complaint against Wirecard for accounting fraud aimed at manipulating the market through the publication of fraudulent financial statements in the period from 2016 to 2018. The next day, 19 June 2020, Markus Braun resigns as CEO of the group, having been unable to react to the events of the past few days.

Three days later, on 22 June 2020, the board of Wirecard finally admits the truth. In a statement, the group says that there is a very high probability that the €1.9 billion, which should have been held in escrow accounts, never existed. The next day, Markus Braun was arrested on charges of fraudulently falsifying the company's accounts in order to manipulate the market. The former CEO is released the same day on bail.

On 25 June 2020, after the revelation of the financial hole, the German fintech giant, Wirecard, is forced to file for bankruptcy, the BaFin instructs the FREP to examine Wirecard's financial statements as of 31 December 2017 and 30 June 2019. On 20 July 2020, BaFin receives a communication from FREP that Wirecard has rejected the results of the examination of the accounts as of 30 June 2018 and 31 December 2018 and also refuses to cooperate for the accounts as at 31 December 2017 and 30 June 2019. Only after this communication can BaFin intervene, fulfilling its duties in the two-tier procedure, by starting its direct examination of Wirecard's financial statements. Two days later, on 22 July 2020, Markus Braun is arrested again together with two others former Wirecard executives by German prosecutors. BaFin's examination of Wirecard's accounts mentioned above only formally begins on 4 August 2020 with the publication in the official gazette.

On 1 September 2020, a parliamentary enquiry is launched to shed light on the Wirecard case, an affair that is anything but transparent. On 24 January 2021, Edgar Ernst, the head of the FREP, the German first tier accounting supervisory authority, resigned from his position following criticism of his management of the Wirecard case.

Five days later, on 29 January 2021, Felix Hufeld, who until now had been the president of BaFin, also resigned. Olaf Scholz, Germany's vice-chancellor and finance minister, announces on 3 February 2021 that he wants to give more powers to BaFin to make it more agile and better able to identify and investigate any misconduct committed by the companies it supervises. In April 2021, Olaf Scholz and Angela Merkel testified before the Bundestag enquiry committee on the Wirecard case to clarify their role in the scandal. Both rule out any interference by the German government in the events leading up to the Wirecard scandal. I would like to remind the reader that the investigations into the Wirecard case are still in progress and therefore no final verdicts have been reached.

In the figure below (Figure 17), I have reported a graph made by the Financial Times that highlights the relationship of Wirecard's share price with the most important events in its history between 2018, the year of its listing on the DAX30, and 2020, the year of its bankruptcy.

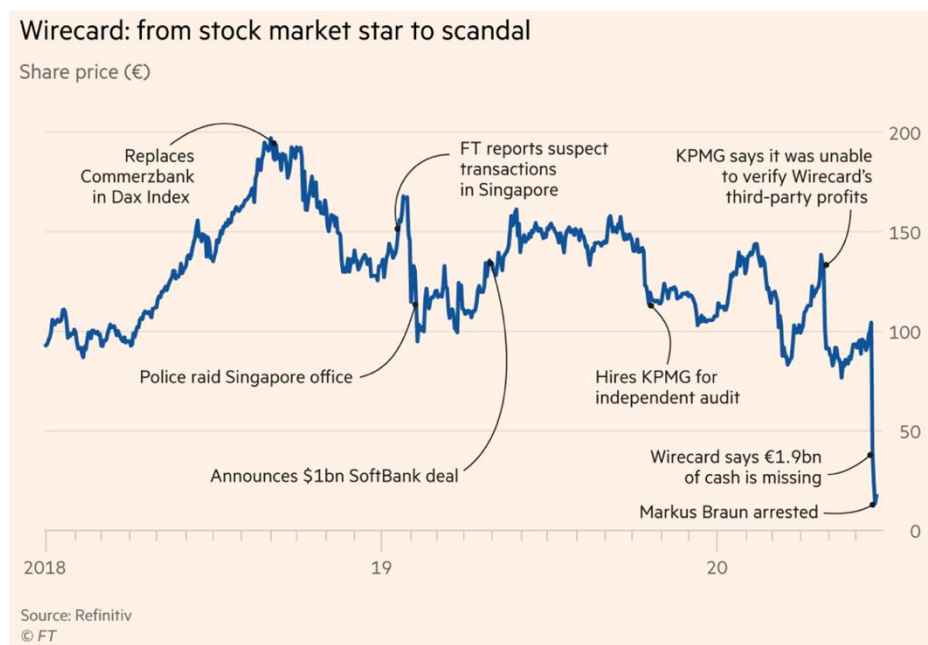


Figure 17 – Source: McCrum, 2020¹⁰⁶

In the following paragraphs, I will present the failures of the market defense lines that made this scandal possible.

4.2 How was it possible?

In the following paragraphs, I will analyse what this thesis has identified as the main deficiencies and critical issues that made possible the fraud committed by Wirecard. I will start by presenting one of the most important criticalities in this story, the failure to properly flow information to the market. Subsequently I will analyse the shortcomings that each supervisory body involved in the Wirecard case has demonstrated.

4.2.1 Information flow failure

In this section I will present what this thesis has identified as one of the main issues that fostered the collapse of Wirecard, the malfunctioning of the information flow in prices. In order for capital markets to function

¹⁰⁶ McCrum D. (2020). Wirecard: the timeline. *Financial Times*.

properly and efficiently, the prices of securities admitted to trading must be as precise and accurate as possible.

This price accuracy is ensured by a proper flow of information, which, once incorporated, causes the price of a given security to rise or fall – trivially, buy and sell orders are also market information, the first giving rise to a price rise, the second to a price fall. When the information is not correctly incorporated into prices, it gives rise to prices that are under- or over-estimated and is therefore a threat to the correct functioning of the markets. The proper functioning of this information flow should be ensured by market supervisors so as to inspire confidence in investors that the market is functioning correctly and fairly. In the Wirecard case, something went wrong with this flow of information and the authorities that were supposed to ensure its proper functioning failed in this task and, in some cases, were complicit in the malfunctioning, as we shall see. There are various information channels that play their role in this flow of information, and in this thesis, I will focus on those in which serious deficiencies have been detected.

The first channel that I will discuss is formed by whistleblowers and journalists who, through their insider information and investigative articles, make a fundamental contribution to price accuracy and the detection of potential fraud. The second channel that I will discuss is composed of short sellers who, through their positions on the market, disclose negative information to the market, that they possess but which is not yet reflected in market prices. If the share prices had reflected their true value, the fraud would probably have been detected earlier or at least fewer investors would have been shocked. As I have shown before in presenting the events in detail, in the Wirecard case all too often the alarm bells rung by these categories of informants have gone unheeded.

Regarding the first channel of information, composed of whistleblowers and journalists, having seen the succession of events, it seems clear that these sources of information, although they tried in every way to inform the market of what was happening, were not taken seriously enough. In fact, since the Financial Times began its "House of Wirecard" series in 2015, the journal has published dozens of articles exposing Wirecard's wrongdoings, many of them with internal whistleblowers as sources. All these articles and reports more often than not were not sufficiently listened to and taken into account by the supervisory authorities, in the worst cases the authors of these articles were even prosecuted by BaFin.

This behaviors on the part of the supervisory authorities meant that this information was not even adequately taken into account by the market, thus preventing it from being incorporated into market prices. In defense of the supervisory authorities, it can be said that there are often numerous whistleblowers and newspaper articles that usually try to discredit companies with success stories, it is always possible that there are dissatisfied former employees or in the worst cases criminals with market manipulation intentions. Supervisory authorities, however, should be able to distinguish between those who unfoundedly attack a

company and those who report fraud. Supervisory authorities should probably be more encouraged to take in, or at least analyse more thoroughly, information from these sources. Better still, they should encourage employees who discover irregularities within their companies to report them, so that the flow of information is more efficient.

Regarding the second information channel to be discussed in this thesis, the one formed by short sellers, they provide the market with crucial information. In fact, short sellers decide to open their selling positions on the basis of negative information about a company they own that is not reflected in market prices. Their function is also fundamental as a thermometer to assess the state of well-being of a given company. BaFin, in the Wirecard case, through its actions not only failed to allow such information to be incorporated into the market but also unwittingly reassured investors about Wirecard, thereby causing even more damage. Indeed, through the institution of the short selling ban on 18 February 2019, BaFin created an information asymmetry in that the price fluctuation of Wirecard's securities was only limited in one direction. In cases like this, during the ban period, market prices fail to reflect the actual value of the security resulting in an overstated one. Investors therefore during this ban period not only continued to buy Wirecard securities, which reassured by BaFin's actions, were convinced that the short sellers were in the wrong but did so at a higher price than was fair due to the above-mentioned asymmetry. In order to issue a short selling ban, a national competent authority needs to be satisfied that there is a real threat to financial stability and to market confidence as a whole. The issuance of such a ban is subject to approval by ESMA, which assesses its proportionality. According to BaFin, the ban has become necessary following a visible increase in the volatility of Wirecard's securities after the Financial Times' publication on 30 January. According to BaFin, this increase in volatility could be interpreted as a lack of confidence on the part of investors in the correct formation of market prices and could therefore extend its negative effects to the other shares in the DAX30. ESMA in the course of its duties commented and assessed this intervention, stating that: "*The current circumstances related to Wirecard are adverse events or developments which constitute a serious threat to market confidence in Germany, and that the proposed measure is appropriate and proportionate to address the threat to German financial markets*"¹⁰⁷. It would probably be appropriate to provide more stringent constraints on NCAs to institute short selling bans or less drastic intervention actions. From this brief analysis it is clear that the flow of information in prices did not function properly, thus preventing early detection of fraud. In the following paragraphs I will focus my attention on the supervisory bodies that were not able to identify the fraud perpetrated by Wirecard.

¹⁰⁷ ESMA official website (2019). Search for "*ESMA issues positive opinion on short selling ban by BaFin*".

4.2.2 Company's internal control system and Supervisory board failure

The first major line of defense for markets and investors against accounting manipulation and fraud is the company's internal controls. In Germany, these controls are not audited, in contrast to, for example, the United States, where after various accounting scandals the auditing of these internal controls was made mandatory¹⁰⁸. This audit concerns the assessment of the adequacy of the company's internal accounting fraud detection controls. In Germany, on the other hand, there is an obligation on management to implement an early warning system as part of the risk management system, and only this system is audited. The Wirecard case has shown that internal company controls are often not sufficient to detect accounting fraud. In fact, Wirecard's management failed to pick up on obvious warning signs, and even, in some cases, ignored alarm bells from internal whistleblowers. In order to avoid such failures, it would be desirable to introduce stricter rules with a broader obligation to audit the internal controls of companies. Otherwise, in order to avoid such an invasive and costly obligation, a random inspection, taking into account companies' risk assessment, of internal controls by market supervisors, BaFin and FREP, could be introduced. To ensure the proper and effective functioning of the financial markets, it is essential that all listed companies have an adequate internal control system. A key body that makes up this system of internal supervision is the supervisory board; its responsibility is to oversee the work of management. In order to perform its supervisory role properly, the supervisory board needs to have unrestricted access to relevant information such as documents and financial data. In order to ensure proper supervision, such access to relevant information should be as independent as possible from the management of the company. In addition, the supervisory board must also have enough dedicated and adequately trained staff to be able to process the information subject to supervision. In the Wirecard case, nothing can be said about the adequacy of the number or experience of the staff, while doubts arise with regard to independence from management¹⁰⁹. Even the supervisory board was unable to identify fraud and falsification in the information provided to it by management. With regard to the external audit, however, for companies listed on German regulated markets there is an obligation for audit firms to report to the supervisory board of the audited companies on the audit of the financial statements carried out and, on any deficiencies, identified in the systems implemented by management to prevent fraud¹¹⁰. In order to properly analyse and understand the information received from audit firms the supervisory board must be equipped with sufficient, appropriately professional dedicated staff. At the moment, however, not all companies listed on regulated markets in

¹⁰⁸ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

¹⁰⁹ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

¹¹⁰ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

Germany equip their supervisory board with committees dedicated to audit analysis, among them Wirecard. There are no precise indications or obligations of the German government on the establishment of dedicated committees, although it is recommended in the German Corporate Governance Code¹¹¹. It should be noted that Wirecard's internal control system and supervisory board on the whole did not do a very good job. Their failure to uncover the fraud at the forefront allowed the company to continue to defraud investors undisturbed. In fact, given Wirecard's apparent good health, buy recommendations outweighed sell recommendations from analysts and financial experts virtually every time, with the exception of attacks by short sellers, which were promptly silenced by BaFin. Even Moody's, the famous rating company, kept its investment grade for Wirecard stable and positive for the duration of 2019, until the €1.9 billion hole was discovered¹¹². Institutional creditors and large shareholders could, according to the law, have requested information and more details about Wirecard's true state of health. However, there is no evidence of any such action, and it is likely that external and internal investors have based their opinions on information disclosed by the company and its management.

4.2.3 External audit failure

In this paragraph I will analyse what this thesis has identified, after the analysis of events, as the main element around which the Wirecard scandal revolves: the failure of the auditing firm to detect fraud and accounting manipulation. Audit firms have the external front-line task of supervising listed companies. In Germany, as in the rest of Europe, the Transparency Directive requires all companies whose securities are admitted to trading on regulated markets to provide a continuous flow of financial information (e.g., half-yearly or annual financial reports). The fact that a listed company provides a flow of financial information is not sufficient to ensure the proper and efficient functioning of the market. To function properly, it requires that this flow of information is correct and reliable, so that the right information is incorporated into market prices.

The role of auditing companies is to audit the financial statements of listed companies, ensuring that they comply with accounting standards and that the information they contain is true and reliable. Audit firms play a key role in trying to bridge the information asymmetry that exists between outside investors and those who manage listed companies. Auditors are able, through their high level of professionalism, to analyse and understand the complex and often opaque information contained in companies' financial statements. In carrying out their audit, the auditors can of course access the books of account, but they can also ask the

¹¹¹ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

¹¹² Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? Economic Governance Support Unit (EGOV) Directorate-General for International Polices.

audited company for additional information and possibly extra documentation. In order for an audit opinion to be reliable and credible, it is essential that there is a relationship of complete independence between the auditor and the audited company. If there is no such independent relationship between the auditor and the audited company, the credibility of the audit firm may be damaged. A reduction in the credibility of the audits carried out by the audit firms could, however, have a negative effect on market efficiency. Investors may react by having little confidence in the companies' reported and audited figures, thus leading to a higher market price to compensate for the uncertainty risk.

In the Wirecard case, the auditing firm that was supposed to oversee the accuracy of the fintech company's financial statements was Ernst & Young. The auditing giant, part of the Big Four, was hired by Wirecard in 2008 in response to one of the first allegations in its history. From then on, EY remained Wirecard's auditing firm for over twelve years until Wirecard filed for bankruptcy. It is evident from the outset that there has been a solid and strangely long-lasting relationship between the two companies, which raises doubts about the independence of this relationship. EY audited Wirecard's financial statements for twelve years without ever noticing the fraud, despite the various warning signs that emerged over the years, such as various attacks by short sellers and negative articles in the Financial Times. The auditing firm always relied on the data and information provided by Wirecard without ever investigating and verifying these numbers. After the discovery of the €1.9 billion hole, EY Partners who signed off on Wirecard's financial statements between 2016 and 2018 and employees who played prominent roles in the fraud are under criminal investigation¹¹³. The investigations against EY employees began after the Audit Oversight Body informed the German prosecutor that there are suspicions that EY may have acted criminally while carrying out its work for Wirecard¹¹⁴.

The Wirecard case, like many other European and non-European accounting scandals (e.g., Enron or Parmalat), highlights the weakness of the system for auditing the financial statements of listed companies. One of the major problems that this thesis identifies in this system is that the auditing firm is chosen by the company to be audited and the latter is also responsible for the remuneration and the duration of the relationship with the auditing firm. This could give rise to conflicts of interest, creating an incentive for the audit firm to accommodate and please its client, the company which must be audited. In order to mitigate this risk, the market relies on the AOB, which monitors the performance of audit firms; it relies on the negative image effect that an audit firm would suffer if it were to be involved in an accounting scandal; it relies on the auditor's liability, which is provided for by law in the event of an audit firm's involvement in an accounting scandal; and finally it relies on competition between audit firms, which should ensure that they

¹¹³ Storbeck O. (2021). EY's Wirecard audits suffered serious shortcomings, German probe finds. Financial Times.

¹¹⁴ Storbeck O. (2021). EY's Wirecard audits suffered serious shortcomings, German probe finds. Financial Times.

offer quality services. As seen in the preceding paragraphs, however, the audit market in Germany is characterized by a very high level of concentration and thus little competition, with the Big Four sharing almost 100% of the market share. This in itself does not imply a decrease in quality but could certainly be a cause. Regarding the liability of auditors, in many EU countries liability is limited, and, in the specific case of Germany, the penalty amounts to €4 million¹¹⁵. Such insignificant penalties compared to the multi-billion-dollar capital of the large auditing firms detracts from the effectiveness that the negative reputational effects would have on auditing firms.

It is important to note to the reader that EY is not the only auditing firm involved in financial scandals such as Wirecard, all the Big Four firms have had to deal with one during their history.

A further problem with the external audit system of listed companies, which according to this thesis may have led to a decrease in the efficiency of the market to incorporate information, is that the information and data of the audit process are largely unobservable by the market. The information the market receives is the result of the review, not the data and information on which the review is based. However, this is a problem that is difficult to solve, as audit firms do not share such information for justifiable reasons, the data and information on which their audits are based is confidential information and often data that cannot be disclosed by contract.

Furthermore, it is already difficult for outsiders and the market to understand and analyse audit results, let alone the even more complex data on which they are based. It is still too early to say whether Ernst & Young's oversight was at fault, as investigations are still ongoing, but this scandal has certainly raised awareness of the evident weaknesses in the auditing system of listed companies. Europe should learn from and build on this scandal so that it will be better able to avoid similar scandals in the future by strengthening the supervisory system for companies listed on European regulated markets.

4.2.4 Failure of the supervisory bodies for financial reporting and auditing

As a last instance, in this last paragraph I will analyse what have been identified as the major deficiencies of the national supervisory system. The failure to identify fraud by auditors continues to be key in this analysis as it brings to light the failings that there were on the part of AOB in supervising auditors. Another element that gains a fundamental importance in the analysis of the shortcomings of the national supervisory system is, instead, the failure to identify fraud by the market supervisors, which in Germany are FREP and BaFin. In

¹¹⁵ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

this concluding paragraph of the third chapter, therefore, I will analyse what may be the causes of such failures on the part of the bodies that make up the German national supervisory system.

Firstly, as we have already seen in the previous paragraphs, following financial scandals such as Enron and Parmalat, the need to provide for an accurate flow of financial information has emerged. Audit firms play their fundamental role in monitoring and reviewing this flow of financial information. It is essential for the proper functioning of the market that investors have confidence in the audits conducted by auditing firms. In order to increase this confidence and to assure the market of a higher quality of audits in Germany, there is the Audit Oversight Body.

The AOB has the power to inspect audit firms and, if it deems it necessary, to examine in detail the audit charters of specific companies. Through this monitoring of the auditor, the market should be assured of a certain level of audit quality, and accounting fraud should be more likely to be detected in advance. The AOB therefore carries out regular inspections of the auditing firms that audit the financial statements of companies whose securities are listed on German regulated markets. The auditing firms inspected by the AOB are chosen according to a random risk-based method which takes into account the riskiness of the auditing firm's engagements.

However, it is important for the reader to note that the AOB does not clearly communicate the results of its inspections, but instead only publishes an annual report containing the results of its inspections in the aggregate without focusing on the individual engagements of the auditing firms. This is always due to the confidentiality and secrecy agreements that audit firms enter into with the companies they audit. This inability on the part of the AOB to provide more precise communications regarding the various engagements of the audit firms and the fact that the results of the reviews are only available in the aggregate means that the market is not really able to analyse all the information necessary to determine the correct level of confidence and the correct market price for the securities.

In the Wirecard case, it is important to note that Ernst & Young, Wirecard's auditing firm, even during the most suspicious years continued to sign off the company's financial statements without qualification and without identifying any oddities. In fact, EY issued unqualified opinions for Wirecard's financial statements between 2015 and 2018 without much difficulty. This is at least suspicious given the attacks Wirecard received during those years, indeed I recall that as early as 2015 the Financial Times began its series of investigative articles into the company's misconduct and in 2016 Wirecard was instead at the center of an attack by a group of short sellers under the name of Zatarra. Ernst & Young probably did not give due consideration to the attacks Wirecard received during those years, note however that the AOB was not even able to identify the fraud or misconduct, nor did it request any special insights from EY into the Wirecard

case, evidently also giving too little weight to the alarm bells that were there. In several articles in the Financial Times by Olaf Storbeck, EY is accused of being inaccurate, having relied only on the information provided by Wirecard without further investigation. EY was unable to identify the fraud despite the fact that there were also several internal whistleblowers over the years.

Given its size, the AOB certainly examined EY on an annual basis, but due to the publication of the results of the examinations in aggregate it cannot be said with certainty that EY's and Wirecard's relationship was subject to scrutiny. It was only in October 2019 that the AOB formally launched a preliminary investigation which converted into a formal professional oversight procedure a few months later, in May 2020, following the publication of the forensic report conducted KPMG, this formal investigation is still ongoing. In the AOB's defense, however, it can be argued that the identification of fraud is more the responsibility of the internal supervisory board or secondarily of the external audit firm.

The main task of the AOB is to check that the audits carried out by the audit firms are in line with accounting standards. Even so, a proper audit that contributes to the proper functioning of the markets goes beyond simply verifying compliance with accounting standards. Supervisory bodies should be more critical, pursue their suspicions and not look the other way to prevent such scandals, which undermine investor confidence.

I will now present what have been identified as shortcomings in the actions of the national market supervisors, BaFin and FREP. As already mentioned in the previous paragraphs, Wirecard – not being classified as a financial institution – did not fall under the direct supervision of BaFin but instead fell under the two-tier financial reporting enforcement procedure, which is firstly conducted by FREP and in particular cases in second instance by BaFin. These two bodies were the ones charged with the supervision of the financial reports of the Wirecard group, which, as has been amply seen, were unable to identify the fraud perpetrated by Wirecard. In conducting my analysis of the deficiencies of FREP and BaFin I will draw on the precious findings of the Fast-Track Peer Review conducted by ESMA in November 2020. I will begin this analysis by focusing first on FREP and only then on BaFin.

The relationship between the FREP and Wirecard began at the end of 2014, when in December of that year the FREP selected Wirecard's annual financial reports for review. Wirecard's financial reports were selected on a random basis, it was therefore a causeless examination, the FREP had no clear evidence of suspected misconduct. This examination lasted approximately two years, in fact it ended in December 2016 with FREP reporting that there were no indications that the accounts were incorrect or misleading. During the two years of inspection, however, Wirecard repeatedly became the focus of various newspaper articles and reports from short sellers accusing it of accounting fraud and misconduct. The FREP has, on each occasion, been urged by BaFin to take these articles and reports into account when carrying out its investigations into

Wirecard's financial statements. The FREP has always maintained that the result of the examination was also achieved by taking into account all allegations and information present at the time. Almost three years later, in February 2019, the FREP selected Wirecard's 2018 annual financial statements for examination, this time the selection was not the result of a random method, but the risk-based method seen above. A few days later, however, the FREP was commissioned by BaFin to conduct a focused examination of Wirecard's 2018 mid-year financial reports following new allegations attached to Wirecard by the Financial Times. It should be noted that this latter examination of the 2018 mid-year financial reports, which was based on a request from BaFin, had a higher priority than the examination of the 2018 annual financial reports which was instead based on FREP's random risk-based selection. After more than a year, the FREP inspections were still ongoing, when the special forensic audit conducted by KPMG on Wirecard's financial statements ended in April 2020. When those findings were published, BaFin instructed FREP to take those findings and the recent FT articles into account when conducting its own review of Wirecard's 2018 mid-year financial reports. In the same month, April 2020, BaFin instructed FREP to conduct a new examination focused on the 2018 annual financial reports. On 22 June 2020, Wirecard states that €1.9 billion, which should have been contained in escrow accounts with two Philippine banks, does not actually exist. On the same day, FREP is instructed by BaFin to take this information into account when conducting its examinations. Two days later, the FREP selects Wirecard's 2019 annual financial reports for examination, again based on the risk of misconduct. On 25 June 2020 Wirecard files for bankruptcy, BaFin instructs the FREP to also include this information when conducting its examinations. On 6 July 2020, the FREP publishes the results of its examinations of Wirecard's 2018 annual and mid-year financial statements claiming to have found errors and serious misstatements¹¹⁶. Wirecard responds to these findings by arguing that under the current circumstances it cannot make any comments regarding the results of the examination conducted by FREP. This, as seen in the previous paragraphs, is considered by FREP as a rejection of the findings and therefore it has informed BaFin of this rejection which, only at this point can, consistent with the two-tier procedure of financial reporting enforcement, begin the examination of Wirecard's financial statements itself.

Having looked in detail at the FREP's actions during the supervision of Wirecard it is possible to say that there are no clear and obvious signs of wrongdoing in the FREP's actions. however, it is equally possible to say that the FREP's actions were in some way characterized by a kind of carelessness and superficiality in examining Wirecard's financial reports. As I will show in more detail in the last chapter during the course of the FTFR, not even ESMA has identified any particular shortcomings of FREP in conducting its examinations, in its selection methods or in the level of independence it has towards the government and investors.

¹¹⁶ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

It can be said that even if FREP had a role in this financial debacle, its only fault is that it did not identify the fraud earlier. The same cannot be said for BaFin's actions which, caused real distortions in the market and its proper functioning. As I have already done with the FREP, I will now first analyse in detail the actions taken by BaFin and then try to explain what the deficiencies in its behavior were.

The first action taken by BaFin in the Wirecard case was more than six years ago, in 2016. That year, following the publication of a report by an anonymous group of short sellers known as Zatarra that contained accusations against Wirecard, BaFin intervened by launching an investigation into market participants who had sold Wirecard securities short in connection with the report published by Zatarra. To see another direct intervention by BaFin we have to wait about three years, during which time BaFin witnessed the various and repeated accusations made against Wirecard and only instructed the FREP to take these accusations into account when carrying out its examination of Wirecard.

It was only in February 2019, after the Financial Times published an article accusing Wirecard of increasing revenues through the use of fictitious and backdated contracts, that BaFin intervened again by launching a market manipulation investigation against market participants who were short selling Wirecard's securities based on information from reports published by the FT. Only two weeks later, on 15 February 2019, BaFin requests the FREP to thoroughly examine Wirecard's 2018 mid-year financial statements, to verify the veracity of the accusations made by the FT journalists against Wirecard and more specifically towards the headquarters the Asian business of the group. It should be noted that the FREP had only on 11 February 2019 selected Wirecard's 2018 annual financial reports for its review, through a risk-based selection process. The examination requested by BaFin takes precedence over the examination initiated by FREP a few days earlier as examinations on request are more important than those initiated by FREP. A few days later, on 18 February 2019, following a drop of about 40% in the value of Wirecard securities, BaFin issued a short selling ban on Wirecard securities with a duration of two months to safeguard economic stability¹¹⁷. As required by the procedure, BaFin, in order to issue such a ban, notified this decision to ESMA, which promptly issued its opinion on the ban. ESMA assessed this ban and confirmed that this intervention was justified and proportionate to the risks to stability that could have resulted from this excessive volatility of securities. Subsequently, on 29 March 2019, the Financial Times published a new article containing allegations against Wirecard, in which it casts doubt on the true extent of the business volume related to Wirecard's Asian TPAs, in the article it is questioned whether indeed the customers claimed by Wirecard really exist. Shortly afterwards, on 10 April 2019, BaFin launches a criminal complaint for market manipulation related to the reports on Wirecard towards some market participants and two journalists from the Financial Times. On 25 October 2019, following a new accusatory article in the FT alleging that 95% of Wirecard's revenues are

¹¹⁷ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza*, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre.

attributable to only three TPAs based in Asia, BaFin instructs FREP to take this information into account during the ongoing review of Wirecard's 2018 mid-year financial reports. Following these allegations Wirecard instructs KPMG to conduct a special forensic audit of its financial statements.

On 29 April 2020, after two ad hoc communications made by Wirecard's CEO regarding the progress of the forensic audit conducted by KPMG, in which it was implied that no irregularities had been found during the course of the investigation, BaFin criminally charges Wirecard with suspected market manipulation as a result of communications made ad hoc to reassure investors about an audit still in progress.

On 22 June 2020, Wirecard issued a notification stating that the €1.9 billion, which was supposedly held in escrow accounts in two Philippine banks, most likely never really existed. BaFin immediately instructs the FREP to take this information into account when conducting its examinations of Wirecard's financial reports. At the same time, BaFin places Wirecard Bank under special observation in order to prevent possible systemic risks.

Two days later, on 24 June 2020, BaFin instructed the FREP to conduct an examination of the mid-year 2019 financial reports. The next day, 25 June 2020, Wirecard files for bankruptcy, BaFin then instructs the FREP to conduct an examination of the 2017 annual financial reports.

On 6 July 2020, the FREP publishes the results of the examination of the 2018 mid-year and annual financial reports and concludes that several accounting errors were identified. Wirecard is not in a position to comment on the FREP's findings under the circumstances and this is interpreted as a rejection of the findings. In accordance with the Two-Tier financial reporting enforcement procedure, FREP informs BaFin of this rejection and at the same time provides it with all reviews and results achieved to date. At this point, on 24 July 2020, BaFin, fulfilling its duty, begins its examination of the 2018 mid-year and annual financial reports, the 2019 mid-year report and the 2017 annual report.

After this brief summary of the actions taken by BaFin during the course of the Wirecard case, I will now attempt to identify what were the deficiencies and what were the consequences of those actions. From the actions made by BaFin, it becomes clear from the outset that the supervisory body has always fought to defend Wirecard against the allegations until the last months of the fintech giant's life.

From the very first accusations, BaFin reacted with a protective attitude towards the German fintech jewel, denouncing and prosecuting the accusers. This behavior not only allowed Wirecard to continue its fraud, but also helped to convince the market of Wirecard's actual innocence, thereby distorting the available information about the company. Even in February 2019, when BaFin issued the short selling ban on Wirecard's securities, BaFin's actions had a distorting effect on the market. Indeed, as I mentioned earlier, through the issuance of the short selling ban, BaFin prevented the market from incorporating all available information to determine the market price of Wirecard's securities, having limited one-way price volatility (during a short selling ban it is prohibited to sell the securities of the company involved, not buy them). The

reasons for this over-protection of Wirecard by BaFin are probably to be found in a kind of "home country bias" of the supervisory body towards the German flagship¹¹⁸. In fact, since most of the accusations came from across the border (as they were made by the Financial Times), a kind of national pride on the part of BaFin came into play, which felt obliged to defend the German giant against foreign attacks that, in its view, aimed at damaging Wirecard, hence the term home country bias. In fact, even though BaFin is a public body accountable to the Ministry of Finance (MoF), during the years 2016 to 2020 BaFin provided reports to the MoF about Wirecard at least 17 times, which seems suspicious to say the least¹¹⁹. Of these reports, however, three were provided in 2016 while the remaining fourteen reports were provided over a period of time from 2019 to 2020, a disproportionately high number. BaFin justified this high frequency of reports provided to the MoF by saying that they were necessary due to the extraordinarily special and sensitive circumstances of the Wirecard case¹²⁰.

It should also be noted that after the discovery of the scandal, it was discovered during the investigation that a small proportion of BaFin employees involved in the supervision of Wirecard possessed and traded Wirecard securities or derivatives related to Wirecard during the course of their supervision mandate¹²¹. I will elaborate in more detail on these issues of BaFin's independence from the German government and investors in the next chapter through the analysis of the Fast-Track Peer Review conducted by ESMA in November 2020.

¹¹⁸ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹¹⁹ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹²⁰ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹²¹ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

5. Which are the future challenges?

In this final chapter, after analyzing all the events surrounding the Wirecard case, I will try to summarize what this case has taught us and made us understand. In this chapter, I will try to understand what changes should be implemented to strengthen the market supervision system so that such scandals do not happen again in the future.

To this end, I will first focus on analyzing the results of the two evaluation processes addressed by FREP and BaFin. Indeed, the German supervisory bodies were subjected to an evaluation both in 2017 through a Peer Review and in 2020 after the scandal through a Fast-Track Peer Review.

In the first paragraph I will focus my analysis on the findings of the Peer Review conducted by ESMA in 2017. This Peer Review was not specifically focused on BaFin and FREP but instead was a review conducted by ESMA to assess the level of harmonization of national supervisory procedures across 31 different eurozone countries. ESMA conducted this assessment by evaluating the NCAs' compliance with the Guidelines issued by ESMA. Already this analysis, prior to the scandal, revealed weaknesses in the German financial reporting supervision system, and BaFin declared non-compliance with two of ESMA's Guidelines 7 and 17.

After this brief analysis of the findings from the 2017 Peer review, I will instead focus on the assessment of the German supervisory system after the collapse of Wirecard. To this end, in the second section I will focus on the results of the Fast-Track Peer Review conducted by ESMA in November 2020 at the request of the European Commission. This review unlike the Peer Review is a new reaction tool provided to ESMA after the 2019 ESAs Review. Through the FTPR, ESMA has been tasked to assess any shortcomings identified in the supervisory process carried out by FREP and BaFin with respect to Wirecard. The FTPR is an ex-post analysis conducted by ESMA on the adequacy of the two national supervisory bodies, BaFin and FREP. In this analysis, ESMA assesses these two entities with regard to their compliance with key Guidelines 2, 3, 5, 6, 8, 9 and 12. These GLEFIs set standards with respect to the number of resources to be deployed during an examination and their professionalism, with respect to the level of independence from government and issuers that should be maintained by national supervisors, with respect to the method of selection and the method of conducting examinations conducted by national supervisors, with respect to the relevance of the actions of the supervisory bodies, with respect to whether the national supervisory bodies enforce the actions taken by the companies against which they have been taken, and finally with respect to the possibility for NCAs to share information about examinations before they reach a verdict. In my research, I will focus on the analysis of the FTPR's findings regarding compliance with the three GLEFIs, which identified as the main critical issues: the adequacy of the number of resources employed by the two supervisory bodies and their level of

professionalism; the adequacy of the level of independence of the two bodies with respect to government and issuers; and finally, the adequacy of the selection method used by the two supervisory bodies in selecting the companies under examination.

After this analysis of the Peer Review and the FTPR conducted by ESMA, in the last paragraph, I will attempt to make a compilation of all those reforms and actions that could be implemented in the system of supervision of regulated markets to prevent scandals like the Wirecard one from happening again in the future. It is indeed fundamental to grasp what the Wirecard case has to teach us, we should not consider the Wirecard debacle only as a fraud that has undermined European financial stability, but it should be interpreted as an opportunity to strengthen the European supervisory system and make European markets more united and harmonized, so as to increase their efficiency and provide investors with more positive externalities.

5.1 Assessment of the German two-tier financial reporting enforcement procedure

In these paragraphs, I will focus on the two evaluation processes conducted by ESMA regarding FREP, BaFin and their two-tier financial information enforcement process: the 2017 Peer Review and the 2020 Fast Track Peer Review. The two reviews are very different from each other both in terms of the subject matter and the reasons that made them necessary. In fact, the first one was conducted by ESMA in the performance of its duties with the aim of assessing the level of harmonization between different eurozone member countries, including Germany and therefore FREP and BaFin. The second analysis, conducted in 2020, was carried out by ESMA at the request of the European Commission and focused on the Wirecard case to assess its implications. This second analysis was conducted by ESMA using the brand-new tool introduced by the 2019 ESAs review: the Fast-Track Peer Review. This tool, unlike the Peer Review, is an event response tool, which can only be used in certain circumstances, and its intervention was requested to assess possible responsibilities of BaFin and FREP in the failures to supervise the Wirecard collapse.

In the first paragraph, I will give the reader an opportunity to understand that already in 2017, weaknesses in the German supervision process had emerged and ESMA had also recommended improvements that could be made to this supervision process. The 2017 Peer Review did not focus on the German supervisory system but instead on that occasion ESMA analyzed the national supervisory systems of 31 Eurozone member countries to assess their compliance with the GLEFIs and their harmonization as a whole.

In the second section, however, I focus on analyzing the results of the Fast-Track Peer Review conducted by ESMA in November 2020. As mentioned above, this review was conducted by ESMA to assess the compliance of the two-tier financial reporting enforcement process with certain GLEFIs issued by ESMA. In fact, the review aims to assess the compliance of BaFin and FREP with seven key guidelines, namely 2, 3, 5, 6, 8, 9 and 12.

These guidelines concern respectively the number of resources to be deployed during an examination and their professionalism; the level of independence from government and issuers that should be maintained by national supervisors; the method of selection and the method of conducting examinations conducted by national supervisors; the relevance of the actions of the supervisory bodies; whether the national supervisory bodies enforce the actions taken by the companies against which they have been taken; and finally the possibility for NCAs to share information about examinations before they reach a verdict¹²².

In my research, I will focus on the analysis of the FTPR's findings regarding compliance with the three GLEFIs, which identified as the main critical issues: the adequacy of the number of resources employed by the two supervisory bodies and their level of professionalism; the adequacy of the level of independence of the two bodies with respect to government and issuers; and finally, the adequacy of the selection method used by the two supervisory bodies in selecting the companies under examination.

5.1.1 Analysis of the Peer Review conducted by ESMA in July 2017

Before focusing on the FTPR conducted by ESMA in 2020 on the behavior carried out by BaFin and FREP during their supervision in the Wirecard case, I will focus on the Peer Review conducted, again by ESMA, in 2017. Already in 2017, BaFin and FREP were under scrutiny by ESMA as part of a broader analysis. In 2017, ESMA conducted its Peer Review to assess the level of supervisory convergence across European member states. ESMA assessed this supervisory convergence through the verification of the European NCAs' compliance with the GLEFIs.

One of the most important tasks of ESMA is to issue the Guidelines, some of which concern the Enforcement of Financial Information, hence the name Guidelines on Enforcement of Financial Information (GLEFI). The GLEFI issued by ESMA are the Best Practices that national supervisory bodies should follow to ensure proper supervision of financial information. Adherence to and adoption of the GLEFIs is not mandatory for NCAs of member states, as the Guidelines are based on a method known as *comply or explain*.

Specifically, the 2017 Peer Review was conducted to assess compliance with GLEFIs 2, 5 and 6, which cover: the adequacy of the number and level of training of resources used during the examination process by NCAs; the adequacy of the selection method used by NCAs to select companies for examination; and the adequacy

¹²² ESMA staff (2014). Guidelines, ESMA Guidelines on enforcement of financial information. *ESMA*.

of the examination method used during the conduct of examinations. In addition, through a questionnaire, ESMA asked the 31 countries involved in the Peer Review which guidelines they did not comply with.

Already from ESMA's presentation of the countries under review and the respective NCAs involved in the supervision process, the peculiarity of the German system is evident: Germany, as mentioned above, is one of the only European countries where two different bodies are involved in the supervision of financial information. In Europe, in fact, there are two national supervisory bodies only in Germany, Austria and Ireland, while all other countries have a single supervisory body (e.g., *Consob – Commissione Nazionale per le Società e la Borsa* in Italy).

As regards the analysis of FREP and BaFin, the Peer Review did not reveal any particular criticism of the guidelines under review. However, ESMA pointed out that FREP's powers of intervention are too limited, all concrete powers of action being reserved for BaFin. ESMA also argued that the selection method used by the FREP appears to be effective but recommended an improvement of the risk assessment model of this selection method¹²³.

In addition, the Peer Review found that due to legal impediments BaFin does not comply with GLEFI 7 (Enforcement Actions) and GLEFI 17 (Publication of enforcement decisions). Guideline 7 concerns the possibility of NCAs in cases where it is necessary to request the reissue of financial statements, request a corrective note, or request an adjustment in future financial statements with restatement of comparatives¹²⁴. Guideline 17, on the other hand, concerns the possibility for NCAs to decide which decisions included in the database may be subject to publication on an anonymous basis¹²⁵.

Due to this non-compliance with these guidelines, BaFin in the Wirecard case was not able to request corrective notes in the case of suspected accounting inconsistencies and could not publish information about the decisions made regarding Wirecard.

To make the reader understand the importance of compliance with the GLEFIs, I will use a comparison with another member state: Italy. In Italy, the supervision of financial information is the responsibility of Consob, which complies with all the Guidelines issued by ESMA. In fact, respecting GLEFI 7 and 17, Consob in the case of Wirecard would have had the possibility to request the issuance of a corrective note on the balance sheet to verify possible frauds or would have been able to publish information concerning the decisions taken regarding the supervised company. Moreover, being the only entity involved in the process of supervision of financial information in Italy, Consob would have had all the necessary powers of intervention to supervise more accurately in the Wirecard case.

¹²³ ESMA staff (2017). Peer Review on guidelines on enforcement of financial information. *ESMA*.

¹²⁴ ESMA staff (2014). Guidelines, ESMA Guidelines on enforcement of financial information. *ESMA*.

¹²⁵ ESMA staff (2014). Guidelines, ESMA Guidelines on enforcement of financial information. *ESMA*.

5.1.2 Analysis of the Fast-Track Peer Review conducted by ESMA in November 2020

On 22 June 2020, Wirecard, the German fintech flagship, announced that the €1.9 billion it claimed was contained in escrow accounts with two Philippine banks may never have existed. Three days later, on 25 June 2020, the company filed for bankruptcy and on the same day the European Commission (EC) mandated ESMA to conduct an analysis of the events leading up to Wirecard's collapse and in particular to assess the adequacy of the response put in place by FREP and BaFin. The European Commission instructed ESMA to conduct this analysis using the new tool introduced by the 2019 ESA review, the Fast-Track Peer Review, which is like a Peer Review but usable in special circumstances that require a prompt and timely response. ESMA has carried out this assessment of the adequacy of the response of the two national supervisory bodies by assessing compliance with the Guidelines on the Enforcement of Financial Information (GLEFI) developed by ESMA in 2014.

The Guidelines on Enforcement of Financial Information set standards for all aspects of the supervision of financial information. Specifically, the GLEFIs assessed for compliance were 2, 3, 5, 6, 8, 9 and 12. These GLEFIs set standards with respect to the number of resources to be deployed during an examination and their professionalism, with respect to the level of independence from government and issuers that should be maintained by national supervisors, with respect to the method of selection and the method of conducting examinations conducted by national supervisors, with respect to the relevance of the actions of the supervisory bodies, with respect to whether the national supervisory bodies enforce the actions taken by the companies against which they have been taken, and finally with respect to the possibility for NCAs to share information about examinations before they reach a verdict.

The GLEFIs analyzed in the FTFR echoes in part those considered in the Peer Review conducted by ESMA only a few years earlier in 2017. The 2020 Fast Track Peer Review differs from the 2017 Peer Review in that it was conducted solely to assess the appropriateness of BaFin's and FREP's conduct in supervising Wirecard. The 2017 Peer Review, on the other hand, was a broader analysis of the national supervision systems of 31 countries among which FREP and BaFin were also analyzed. In 2020, as in 2017, it emerged that BaFin did not comply with Guidelines 7 and 17, leading, among other things, to an inability on the part of the national supervisory body to request corrective nets from Wirecard.

I will focus on the analysis of the FTFR's findings regarding compliance with the Guidelines that were identified as the most critical by my research, Guidelines 2, 3 and 5. They concern the adequacy of the resources used in the examination process and their professionalism, the adequacy of the level of independence of FREP and BaFin from the German government and the issuer (Wirecard) and finally the adequacy of the selection method used by FREP and BaFin to choose the companies to be examined.

With regard to the sufficiency and adequacy of human resources and capital deployed, even though neither FREP nor BaFin were able to identify the fraud earlier, ESMA in conducting its analysis concluded that there were no evident deficiencies. In fact, according to ESMA, both FREP and BaFin used sufficient human and capital resources in the Wirecard case, and the human resources used during the Wirecard investigation were adequately professional and capable of interpreting the complex financial data contained in Wirecard's financial statements¹²⁶. Thus, the quantity and professionalism of the resources used by FREP and BaFin fully meet ESMA's expectations, despite having failed to detect the fraud earlier, the reason for this failure is not the sufficiency of the number and professionalism of the resources used by the two national supervisory bodies.

Regarding the independence of FREP and BaFin from the government and issuers, the two cases have to be analyzed separately given the contrasting results achieved by ESMA. In fact, the analysis conducted by ESMA has shown that FREP fully meets ESMA's expectations regarding independence from government and issuers while BaFin only partially meets these expectations¹²⁷.

In its investigation, ESMA has analyzed the frequency and type of relationships that the two supervisory bodies have had with the government (MoF) in order to check whether there has been any influence from the German government on the actions taken by FREP and BaFin. In addition, in order to assess independence from the issuer, ESMA checked whether during the supervision of Wirecard, FREP and BaFin employees held securities of the company or derivatives linked to it that could reproduce the behavior of a Wirecard security. With regard to FREP's independence from the German government, ESMA concluded that it fully meets expectations and there is no evidence of influence from the side. In fact, FREP, as a private entity and not invested with public powers, does not report directly to the German Ministry of Finance, instead there are quarterly meetings with BaFin to update on the progress of ongoing examinations. In any case, FREP decides its actions autonomously and independently from BaFin and the MoF, through the FTFR ESMA confirmed that also during the supervision of Wirecard this independence was maintained.

On the other hand, with regard to FREP's independence from the issuer, ESMA concluded that no FREP employee involved in the supervision of Wirecard or who had access to confidential information was in possession of Wirecard securities or derivatives that replicate its behavior¹²⁸. So, on the whole, however, as already mentioned, ESMA's expectations regarding FREP's independence have been fully met.

¹²⁶ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹²⁷ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹²⁸ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

This cannot be said of BaFin, which only partially meets ESMA's expectations regarding its independence. In fact, already in its assessment of BaFin's independence from the German government, ESMA identified some shortcomings. There is no clear evidence of any influence of the MoF in BaFin's actions but, since the reports made by BaFin to the MoF specifically on Wirecard were many, frequent and very detailed, it cannot be excluded that there was an influence by the MoF in BaFin's actions.

BaFin formally provided detailed reports regarding Wirecard to the MoF 17 times between 2016 and 2020, three of them in 2016 and the remaining 14 between 2019 and 2020¹²⁹. It is also important to note that these are only the formal reports, the BaFin and the MoF could have come into contact informally (e.g., through phone calls) bringing this already high number of consultations to a higher level.

Since BaFin is a public body that answers directly to the Ministry of Finance ESMA would expect there to be a relationship between the two, what is suspicious is the very high number of reports provided and the level of their detail.

Moreover, some of these reports were provided by BaFin to the MoF before decisions were taken or interventions or actions were carried out, which increases even more the risk that there was an influence by the German government on BaFin's actions. It is for these reasons that ESMA's expectations of government independence were only partially met.

Also, with regard to BaFin's independence of the issuer, ESMA has identified some shortcomings. Indeed, ESMA found that no BaFin employee directly involved in the supervision of Wirecard was in possession of Wirecard securities or derivatives that mimic the behavior of the company's shares. It turned out, however, that a very small portion of BaFin employees who had access to insider information about Wirecard had traded Wirecard securities or derivatives during the period under review¹³⁰.

This revealed that BaFin does not have an adequate system for monitoring staff holdings, as BaFin's policy is that employees are only required to disclose the contents of their financial portfolios when they are hired, and there are no updates on this over the years, so constant monitoring cannot be guaranteed¹³¹. At the moment there are ongoing investigations by BaFin against its employees who have traded Wirecard securities. Also in this case, therefore, the possibility of a lack of independence of BaFin from the issuer cannot be completely excluded. Therefore, overall ESMA's expectations on the level of independence of BaFin from the government and the issuer are partially met¹³².

¹²⁹ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹³⁰ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹³¹ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹³² ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

Finally with regard to the assessment of the selection method used by FREP and BaFin to select companies for examination, ESMA concluded that FREP only partially meets its expectations regarding the selection method in the period 2015 to 2018¹³³. During this period, in fact, the FREP failed to select Wirecard for examination, despite the fact that the company was frequently at the center of allegations by a reputable newspaper such as the Financial Times. Whereas, on the other hand, FREP fully complies with ESMA's expectations regarding the selection method in the period from 2019 to 2020, years in which Wirecard is selected by FREP for examination of the 2018 annual financial reports on a risk basis.

As regards ESMA's assessment of BaFin's selection method, it was found that BaFin largely meets ESMA's expectations regarding the selection method of companies to be analyzed in the period 2015 to 2018 and fully meets them in the remaining period analyzed¹³⁴. BaFin complies with these expectations "largely" and not "totally" during the time period from 2015 to 2018 because, although it instructed FREP on each occasion to take into account the various allegations received from Wirecard during the conduct of its examinations of the company, it failed to instruct FREP to examine Wirecard's financial statements indicted by the allegations. It was only in February 2019 that BaFin directly instructed FREP to examine the 2018 mid-year financial reports. Furthermore, during the conduct of the Fast-Track Peer Review ESMA identified the division of responsibilities between FREP and BaFin as a weakness of these two supervisory bodies. In fact, this division of responsibilities is not very clear, and this could lead to misunderstandings. It should also increase their cooperation and information sharing, although this is a more complicated problem to solve as the information to which they have access is often protected by non-disclosure agreements.

So overall the FTPR conducted by ESMA in 2020 did not reveal any major errors in the behavior of the two national supervisory bodies, but some oversight lapses were identified during the Wirecard case and that is why overall ESMA's expectations regarding the actions taken by BaFin and FREP were partially met¹³⁵.

With regard to the two themes, I have discussed for which ESMA's expectations were only partially met, recommendations have been identified to strengthen these weaknesses. Concerning the level of independence of BaFin, ESMA recommended that in the future BaFin should take its decisions and carry out its actions in complete autonomy to the government, providing reports to the MoF after acting and not before, in order to avoid influences. On the other hand, with regard to the level of independence of BaFin

¹³³ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹³⁴ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹³⁵ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

from the issuer, ESMA advised BaFin to introduce mechanisms to control the securities traded by its employees also during the course of their contract, not only when they are hired¹³⁶. If it turns out that BaFin is not independent from the issuers it supervises, it would be catastrophic for the level of trust in proper supervision in Germany and could lead to financial instability.

Regarding the selection method used by FREP to select companies for examination, ESMA hopes that FREP will take more account of the allegations contained in newspaper articles, especially if they come from reputable newspapers such as the Financial Times. Furthermore, in this respect, ESMA expects BaFin not to rely exclusively on FREP for the analysis of allegations contained in newspapers, BaFin should be able to intervene more directly when it has well-founded suspicions.

After this analysis of the suggestions and possible solutions found by ESMA in carrying out the FTPR, in the next section I will report on the possible reforms, identified by the various scholars and academics who are analyzing the Wirecard case, that can strengthen the system of market supervision, so as to prevent scandals such as the Wirecard one from happening again in the future.

5.2 Further remarks

Wirecard's case shown us the weaknesses of the European supervisory system and specifically of the German supervisory system. This scandal has shown us that the European market supervision system still leaves too much room for the defense of national champions to the detriment of the defense of the market as a whole. In this last paragraph some suggestion of possible reforms and actions that could be implemented to make European markets more efficient and more able to avoid scandals such as the Wirecard scandal in the future will be presented.

It is also essential for the reader to understand that the investigation into the Wirecard case is still ongoing, so new details and new responsibilities may emerge in the future that may alter the implications of the Wirecard case.

5.2.1 Collection of possible reforms and actions that could be implemented

The aim of the suggestions and reforms I will mention in this paragraph is to increase the level of supervision of the European capital market in order to increase its efficiency in allocating capital and its attractiveness for both investors and domestic and international issuers. As previously shown, the most critical issues in the

¹³⁶ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

Wirecard case concern the failure of the supervisory bodies to discover the fraud perpetrated by Wirecard and to listen to the alarm bells that have been raised by all the accusations made against Wirecard. As I already mentioned in the previous chapter, these failures of the national supervisory system could be due to an overly protective attitude of the BaFin towards the German fintech giant, probably due to a home country bias¹³⁷.

What this thesis has identified as the main suggestion to solve this problem arising from home country bias is the introduction of a European Single Capital Market Supervisor (ESCMS) in the European capital market, attempting to replicate the European Central Bank (ECB) and its functioning in the Single Supervisory Mechanism (SSM) used by the European Union in the supervision of the banking market¹³⁸. Such a supervisory body should directly supervise 'systemic', very large companies whose performance is able to influence the financial markets as a whole – just as the European Central Bank directly supervises systemic banks in the SSM. A single European supervisor would have the effect of eliminating national conflicts of interest. The term ESCMS refers to a single supervisory body capable of coordinating and guiding all national supervisors of European member states. This could be achieved either by introducing a new supervisory body - the ESCMS - or by providing ESMA with the necessary powers to perform this task. In fact, if more decisive powers were given to EMSA with regard to the management of NCAs, or at least if the Guidelines it issues were made mandatory, a higher level of harmonization of the supervision processes of the various EU member states could be achieved. The SSM was introduced in Europe after the financial crisis of 2007-2008 to provide the euro area banking market with enhanced prudential supervision of credit institutions based on high-level standards¹³⁹. The Single Supervisory Mechanism consists of a supranational supervisory body, the European Central Bank (ECB), which oversees and coordinates all national banking supervisory bodies, the National Central Banks (e.g., Banca d'Italia in Italy and Deutsche Bundesbank in Germany). The objectives of the SSM are to supervise that credit institutions comply with all prudential requirements, to identify weaknesses in the European banking market and to take action to address these weaknesses.

The Single Supervisory Mechanism therefore has a direct supervisory and coordinating role on national supervisory bodies while, as I pointed out in the first chapter, the European System of Financial Supervision has more of a capital market regulatory role. Hence the suggestion in this thesis for the introduction of a European Single Capital Market Supervisor with the aim of further harmonizing the laws and behaviors applied by national supervisors just as happened with the introduction of the ECB and the SSM.

The establishment of an ESCMS could drastically reduce the risks arising from possible national interests in the supervision process of companies whose securities are admitted to trading on European regulated

¹³⁷ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹³⁸ Langenbucher K., Leuz C., Krahen J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

¹³⁹ European Council official website (2020). Search for "Single Supervisory Mechanism".

markets, such as those suspected to have distorted BaFin's behavior in the Wirecard case. The establishment of such a capital market supervision system would, among other things, reduce the possibility of exploiting legislative arbitrage between different EU member states.

This thesis argues that a reform in this direction could achieve a higher level of unification of European capital markets and ensure greater efficiency and protection for investors operating in them. Such reforms, however, require a great deal of time to develop and a very high level of consensus among the EU member states, so they are unlikely to be introduced in a short period of time.

Instead, I will now present, focusing in more detail on the shortcomings identified in the Wirecard case, what could be the reforms that could be implemented in Germany to strengthen the national supervision system. The first suggestion that this thesis wants to propose concerns the use of the short selling ban. This instrument is an extremely powerful tool at the disposal of the National Competent Authorities but probably given the dangerous distorting effects it could have on the correct formation of market prices (which I have presented in chapter three) it should be used with more caution. Therefore, this thesis recommends the introduction of more stringent requirements for the establishment of short selling bans by NCAs. It also recommends the use of less market-distorting instruments such as the suspension from trading the security in question, which is a symmetric intervention, before resorting to the short selling ban which is an asymmetric intervention.

The second recommendation of the thesis concerns the information contained in the various accusatory articles published against Wirecard and the information of internal whistleblowers. It is recommended to develop a better system of evaluation of such sources of information in order to take more account of early warning signs, because identifying fraud in its initial state could drastically reduce the damage it could cause. Whistleblowing should also be encouraged, as it could provide invaluable information to identify accounting fraud more quickly.

With regard to internal controls and the Supervisory Board of German listed companies, this thesis recommends the development of increased obligations to introduce truly effective control systems. In addition, it recommends the introduction of a mandatory audit analysis team within the Supervisory Board of listed companies, which, as seen in chapter three, is not currently mandatory, in order to ensure greater control over the financial data of listed companies.

As for the external audit, some reform could be introduced in this sector to strengthen it and ensure more reliable and accurate audits to the market. Such a reform should certainly include an increase in the liability of auditing firms, which as I mentioned in chapter three amounts to €4 million, a derisory sum for the multi-billion-dollar balance sheets of these companies. In addition, a reform of this sector should provide for stricter audit firm rotation mechanisms for listed companies, so as to mitigate the risk of too long a

relationship between the audit firm and the audited company, which could give rise to conflicts of interest. In addition, in order to achieve a higher audit quality, a second audit of the financial reports of listed companies could be introduced, which could be entrusted, for example, only to smaller auditing firms, which are not part of the Big Four, so as to ensure not only a double audit of financial reports but also an increase in competition in the audit market.

Finally, a reform of the external audit sector should provide for the AOB to be able to publish the results of its examinations and opinions in an unbundled manner, thus providing information on the quality of the audits carried out by audit firms with respect to each of their different relationships with the companies being supervised. This is because, as seen in the third chapter, at present the Audit Oversight Body does not publish its opinions for each audit performed by the audit firms but instead publishes its opinions about the different audit firms, assessing its audits in aggregate. Furthermore, it should be made clearer what the task of the audit firms is, it cannot be just to check compliance with accounting standards, the financial reports must be analyzed critically, taking into account the information available when carrying out the audits, for example information from newspaper articles or internal whistleblowers.

The last tips of this thesis concern the application of financial reporting in Germany. As I showed in chapter two, the implementation of financial reporting in Germany is characterized by a two-tier procedure. This two-tier procedure can lead to a lack of clarity in the tasks or responsibilities of the two national supervisory bodies, and this thesis therefore recommends replacing the German procedure with the one applied in most European countries consisting of a single supervisory tier. In fact, as also emerged from the Peer Review conducted by ESMA in 2017 such a procedure may lead to slower reaction times to market hazards¹⁴⁰. In fact, since the FREP is a private body with no public powers, it does not have the adequate powers of intervention to carry out its role accurately. It would be more efficient to have only BaFin intervene in the supervision procedure on financial reporting, which instead, being endowed with public powers, has the right powers of intervention or alternatively to endow the FREP with the right powers of intervention. This would lead to a much more immediate responsiveness of the German capital market supervision system. Finally, this thesis feels the need to reiterate the advice given by ESMA in the results of the November 2020 FTPR concerning the need to greatly increase the level of independence of BaFin from the government, the need to introduce control systems on the financial portfolios of BaFin employees to increase the independence of the supervisory body from the issuer and finally the need for FREP to give more consideration and importance to the information available about the companies examined – such as the articles and allegations published on Wirecard¹⁴¹.

¹⁴⁰ ESMA staff (2017). Peer Review on guidelines on enforcement of financial information. *ESMA*.

¹⁴¹ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

Through the implementation of these recommendations, a higher level of financial stability and capital market efficiency should be achieved. I would like to repeat to the reader that, in any case, European markets should aspire to have a supervisory system such as the one presented at the beginning of this paragraph, modelled on the Sigle Supervisory Mechanism.

The Wirecard scandal, as analyzed, has brought to light the shortcomings of the financial audit and audit oversight system in Germany and the urgency of a reform that can remedy these deficiencies and prevent scandals like this from happening again in the future. The German government and regulators, in 2021, one year after the collapse, intervened in this regard by issuing a new law with the intention of strengthening the audit process and its supervision. As of July 2021, Germany has adopted a new law, the Act on Strengthening the Financial Market Integrity (Finanzmarktintegritätsstärkungsgesetz – FISG), which makes important changes to the existing law¹⁴². The main changes implemented by the new law concern precisely the topics covered by this thesis: the system of internal controls of listed companies, their audit and supervision.

Regarding the first line of defense of the market against fraud, the internal control systems of listed companies, the new FISG has introduced substantial changes. The new FISG has introduced substantial changes: from now on, companies listed on German regulated markets are obliged to set up a dedicated audit committee within their supervisory committee; moreover, the law stipulates that there must be at least one accounting expert and one audit expert within these audit committees; finally, the FISG prohibits members of the management board from attending meetings between the audit firm and the audit committee unless expressly requested by one of these two parties¹⁴³.

As I pointed out earlier in this chapter, prior to this law, the creation of a dedicated audit committee within the supervisory board of listed companies was not mandatory, but only recommended. In view of the experience gained from the Wirecard case, the FISG's requirement for such dedicated audit committees to include accounting and auditing experts also appears to be of critical importance. Auditing the financial data of large companies and groups of companies is often very difficult, so it is not enough to have dedicated teams to supervise such audits, it is necessary to ensure that such teams are able to analyse and evaluate the audits reviewed. Finally, the last innovation introduced by the FISG, the prohibition of the participation of management board members in meetings between audit firms and internal audit committees, also appears to be of fundamental importance. Through this law, excessive intervention in the audit oversight process by the management of the listed company could be avoided, reducing the risk of creating potential conflicts of interest and lack of independence on the part of the audit committee or the audit firm.

¹⁴² Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁴³ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

The Act on Strengthening the Financial Market Integrity also introduced innovations with regard to audit firms directly. From now on, the FISG has increased the legal liability of audit firms in cases such as Wirecard by raising the penalty from EUR 1 to 4 million to EUR 16 million without imposing an upper limit. In addition, the new law applied in Germany has reduced the time period for the rotation of audit firms from 7 to 5 years and in any case the relationship between an audit firm and an audited company may not exceed 10 years¹⁴⁴. With regard to the increase in the legal liability of audit firms, the public has expressed contrasting opinions: on the one hand, there are those who believe that such an increase has a positive effect on the market, leading to an increase in the level of audit quality; on the other hand, however, there are those who think that it may have a negative effect on the market, leading to a further increase in the concentration of the audit market. It is crucial to note that even though this aspect of the FISG forces audit firms to be more careful and committed in conducting audits, it could further concentrate the market share in the hands of the Big Four, as they are among the only audit firms that can risk incurring such penalties¹⁴⁵.

The second innovative aspect of the FISG with regard to auditors, the imposition of a 10-year limit on the duration of the auditor's appointment, is a very welcome imposition. As I have shown throughout this thesis, such an imposition had become necessary in Germany, which is characterized by multi-year relationships – many exceeding ten – between audit firms and audited companies – for example the relationship between Wirecard and Ernst & Young lasted more than twelve years. Like Wirecard, however, many other German listed companies have such long relationships with their audit firms. In Germany, the average duration of this relationship increases as the market capitalization of the companies involved increases: for small-caps and micro-caps it is on average eight years, about nine years for mid-caps and thirteen years on average for blue-chips.

Finally, with regard to supervisors, the Act on Strengthening the Financial Market Integrity introduced a radical change in the two-tier financial reporting enforcement procedure. In fact, the FISG has provided for the abolition of the Financial Reporting Enforcement Panel (FREP) with effect from 1 January 2022 – fifteen years after its creation – and the consequent centralization of powers in the BaFin, which will be equipped with all the rights and tools to be able to intervene directly¹⁴⁶. BaFin will be provided with the right to search business and to confiscate documents and any other evidence. This is a critical reform of the German supervisory system, ensuring a more rapid reaction by the competent supervisory body. The increase and centralization of these supervisory intervention powers, however, is not sufficient on its own, it is necessary

¹⁴⁴ Beiter S., Fromholzer F., Hauser J., and Zeidler F. (2021). Consequences of Wirecard Scandal: New Requirements for Corporate Governance and Audit of German Listed Companies. *GIBSON DUNN*.

¹⁴⁵ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁴⁶ Deloitte Staff (2021). Law on Strengthening the Financial Market Integrity. *Deloitte*.

that these powers are correctly and diligently used. Indeed, it should be noted that the most recent major financial scandals took place in countries where there was only one supervisory system (e.g., Enron and Parmalat); it is not enough to have the right tools, you have to know how to use them. The markets and Europe will have the opportunity to assess whether BaFin has learned anything from its mistakes in supervising Wirecard.

The Act on Strengthening the Financial Market Integrity is certainly not a sufficient and comprehensive reform for all the shortcomings identified in the collapse of Wirecard, but it is certainly a good start. Through the adoption of this law, it could be said that there has been an admission of guilt on the part of the German government, which had not implemented a supervisory system capable of identifying fraud and preventing the failure of the fintech giant. By eliminating the second tier of financial reporting enforcement, the German government is bringing itself into line with the other European member states, thereby increasing harmonization. It can be said that the adoption of this new law by the German government is the first step after the collapse of Wirecard towards better functioning, more efficient and more harmonized European markets.

6. Conclusions

European capital markets are powerful tools for ensuring the proper and efficient allocation of capital but are also extremely vulnerable to misbehavior and fraud perpetrated by bad apples like Wirecard, which undermine their proper functioning. The collapse of Wirecard is neither the first nor certainly the last financial scandal to be perpetrated by falsifying accounts. Scandals like this can be found all over the world, for example in cases such as Enron (USA) and Parmalat (Italy). Such scandals happen regardless of the laws and supervisory systems in place in the countries where they occur, since it is often very difficult to identify accounting fraud before it is too late. The aim of this thesis is to analyse the implications of the Wirecard case and to see whether there were any supervisory failures in the German supervisory system. Furthermore, the aim is also to present what lessons can be learned from the Wirecard case and what reforms could be implemented to prevent scandals like this from occurring in the future.

Wirecard filed for bankruptcy on 25 June 2020, after the discovery of a €1.9 billion hole in its balance sheet. The German fintech giant – favored by the high technological level of the sector and the remoteness of the geographical locations in which it operated – was able to carry out its fraud undisturbed for more than five years thanks to a complex revenue falsification scheme. The scandal revealed failures in Wirecard's internal and external supervision. Among these, the most critical are related to the functioning of the two-tier financial information enforcement procedure, and the independence of auditors and supervisors. In fact, the German supervision system, as also emerged from the Peer Review conducted by ESMA in 2017, does not present any particular criticalities, but leaves too much room for ambiguity on the responsibilities and tasks of the two bodies involved, the FREP and the BaFin¹⁴⁷. What is really striking about the Wirecard case is that for many years the company was accused of accounting fraud and suspicious financial behavior but neither the auditor nor the supervisors were able to identify the fraud. This has brought to light the danger of too long relationships between auditors and audited companies in Germany.

In order to fully understand the Wirecard case, it has been first necessary to present all the actors involved in the supervision process and which European directives and regulations more interested. The bodies and companies implicated in the supervision of the Wirecard case are various, ranging from European supervisory bodies to national supervisory bodies to private external audit firms with the duty of auditing the listed companies' financial reports.

¹⁴⁷ Krahen J. P., and Langenbucher K. (2020). The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe. *Leibniz Institute for Financial Research SAFE, Frankfurt*.

Among the **European bodies** involved in Wirecard's supervision process, the most noteworthy is the European Securities and Markets Authority (ESMA). ESMA has a critical importance in the Wirecard affair because, among other things, following the scandal it was charged with assessing – through a Fast-Track Peer Review that consists in evaluating compliance with the guidelines issued by ESMA – the adequacy of the supervision carried out by national supervisors in the Wirecard case.

Regarding **national supervisors**, Germany's peculiar two-tier financial reporting enforcement procedure – until 1 January 2022 – was characterized by the presence of two cooperating supervisory bodies: FREP, a private body recognised by the MoF; and BaFin, a public body invested with public powers and directly accountable to the Minister of Finance and the MoF.

However, this national supervision system did not work properly in the Wirecard case, as the two bodies were unable to identify the fraud and avoid bankruptcy. Indeed, already the Peer Review conducted by ESMA in 2017 had revealed some weaknesses of the German two-tier supervision system. This analysis in fact revealed that the two German supervisory bodies did not comply with certain GLEFIs issued by ESMA and therefore for example did not have the legal power to request corrective notes on the balance sheet from Wirecard. Furthermore, the 2017 Peer Review found that the two-tier system leaves too much room for ambiguity in the responsibilities and duties of the supervisory bodies involved¹⁴⁸. As early as 2014, some scholars published a paper arguing that an integrated financial reporting oversight system, not divided between two oversight bodies, would be better able to identify possible frauds and intervene if any were identified¹⁴⁹. The two-tier functioning of the financial reporting enforcement procedure is a peculiarity in the field of supervision, which is only applied in two countries throughout Europe, Germany and Austria.

One of the major criticisms of the supervisory system in the Wirecard case lies in the inability of the supervisory bodies to give sufficient consideration to the constant accusations received by Wirecard from reputable and trustworthy newspapers such as the Financial Times. The FREP, in fact, did not give enough weight to these allegations when conducting its examinations of Wirecard in the first instance, and thus did not further investigate the accounting health of the fintech company. It can be argued, however, that even taking into account the allegations made against Wirecard, identifying the fraud would not have been an easy task.

Moreover, the high level of technology that characterized Wirecard's business and the fact that it operated in countries far apart (Europe and Asia) made it extremely difficult for FREP to identify the accounting fraud.

¹⁴⁸ Krahen J. P., and Langenbucher K. (2020). The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe. *Leibniz Institute for Financial Research SAFE, Frankfurt*.

¹⁴⁹ Wulf I., Niemöller J., and Rentzsch N. (2014). Development toward integrated reporting, and its impact on corporate governance: a two-dimensional approach to accounting with reference to the German two-tier system. *J Manag Control* 25, 135–164.

The rather low pace of financial supervisors' digital transformation and the fast growth in technology leads to an increase in the technological gaps between supervisors and their regions of responsibility and produce a new phenomenon named "asymmetric technology"¹⁵⁰.

However, given the FREP's limited powers of intervention, even if it had had more concrete suspicions, it could not have done anything directly, since its only possibility under the two-tier financial reporting procedure was to inform BaFin of such suspicions. BaFin also failed to take sufficient account of accusations made against German companies when these came from abroad. BaFin – like FREP – mostly ignored the accusations made by the FT journalists, but – unlike FREP – it sometimes argued that these accusations were false and fraudulent, aimed at manipulating the market. In these circumstances, BaFin – convinced of the innocence of the German fintech giant – intervened filing market manipulation charges against Wirecard's accusers. These interventions were made in good faith by BaFin but had distorting consequences on the market¹⁵¹.

Furthermore, given the numerous reports provided by BaFin to the MoF concerning Wirecard, suspicions arise as to the actual level of independence of BaFin from the German government in performing its duties as national supervisor. This lack of independence, as already seen during the thesis, could be due to a sort of *home country bias*¹⁵², which may have prompted BaFin to be less strict towards the spearhead of German fintech, Wirecard.

Another occasion on which BaFin's intervention had a distorting effect was when it issued a ban on short selling on Wirecard securities to preserve the general stability of the financial markets, after a series of attacks by short sellers caused them to fall by 40%. This ban resulted in a distortion of the market prices of Wirecard securities. BaFin issued this short selling ban in good faith, convinced of the willingness of these short sellers to manipulate the market through short selling of Wirecard securities. This intervention had a distorting effect on the market because BaFin – by issuing the short selling ban – limited the volatility of Wirecard securities univocally: Wirecard securities could not be sold, they could only be purchased.

Probably, in order to have fewer distorting effects on the market, BaFin should have resorted to other less invasive instruments, to safeguard financial stability, such as, for example, a suspension of the transactions of the Wirecard securities¹⁵³ – both their sale and their purchase. BaFin's issuance of the short selling ban in February 2021 was the first case in European history in which a national supervisory body issued a two-month short selling ban in defense of a market participant company in order to preserve overall market stability.

¹⁵⁰ Zeranski, S., & Sancak, I. E. (2020). Does the 'Wirecard AG' Case Address FinTech Crises?

¹⁵¹ Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

¹⁵² Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹⁵³ Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

Finally, the last supervisory body that has to be mentioned is Wirecard's auditing firm, Ernst & Young. In fact, EY, as Wirecard's auditor, was responsible for checking that the company's financial reports were correct and reliable and that they complied with accounting principles.

During the twelve years in which EY audited Wirecard's financial statements, the auditing firm failed to identify the fraud and confirmed the financial statements of the fintech giant by relying on the data provided by management in the financial reports. It was only in June 2020 that EY was able – also following the results of the extraordinary audit conducted by KPMG published shortly before – to identify the fraud and refused to confirm Wirecard's 2019 annual financial statements.

The complexity of the business conducted by Wirecard and the fact that it operated in far-flung locations with different accounting laws certainly contributed to making EY's task more difficult. However, the length of the auditing relationship between EY and Wirecard raises doubts about the level of independence of the auditing firm vis-à-vis the audited company. The deficiency in the quality of EY's external audit could also be partly due to a conflict of interest with Wirecard¹⁵⁴. It is important to bear in mind that the auditing firms are paid exclusively by the audited companies, which could give the auditing firms an incentive to be more indulgent in order to safeguard the business relationship¹⁵⁵. Indeed, it seems suspicious that the auditing firm never noticed the missing EUR 1.9 billion, which was supposed to be held in two Philippine banks of which Wirecard was never even a customer. There are still ongoing investigations into EY's behavior towards Wirecard, the conflict of interest being only one of several possible causes for the lack of quality in the Wirecard audit. The length of the relationship between EY and Wirecard points to a criticality in the German supervisory system, which allows such long-term relationships between auditing firms and audited companies. Germany is already implementing reforms in order to prevent this deficiency.

In addition to the conflict of interest, another possible cause behind EY's low audit quality could be the very low level of competition in the German audit market. The high concentration of the audit market could lead to a decrease of the general level of audit quality¹⁵⁶.

The audit market in Germany – as in other European countries and more generally in the rest of the world – is virtually 100% concentrated in the hands of four firms, the so-called Big Four. This concentration could lead to a decrease in the effort these firms put into providing quality audits in order to acquire new clients, as they do not need new clients; they already share practically 100% of the market¹⁵⁷. This problem does not

¹⁵⁴ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹⁵⁵ Beerbaum D. O. (2021). The Future of Audit After the Wirecard Accounting Scandal – Proposal for a Change in the Payment Model.

¹⁵⁶ Kallapur S., Sankaraguruswamy S., and Zang Y. (2010). Audit Market Concentration and Audit Quality.

¹⁵⁷ Brown M. (2020). Who Audits Public Companies – Germany. Audit Analytics.

only concern Germany but the whole world, and reforms should be implemented to limit this concentration and thus increase the competitiveness of the audit market.

It has been necessary to present the regulatory environment in which Wirecard perpetrated its fraud, and thus the directives and regulations that were most significant during the unfolding of the collapse of the German fintech.

From the regulatory point of view directives and regulations have been analyzed relating to three different topics: the protection of the market from market abuse, the requirement of constant provision of financial information by listed companies to the market, and the provisions regulating NCAs' power of intervention to restrict short selling.

MAR regulation, in place to protect the market from market abuse, have become essential not only because the fraud perpetrated by Wirecard can be considered market manipulation, but also because BaFin has repeatedly used them to accuse the authors of the accusations against Wirecard of market manipulation – convinced that the authors of the accusations were in bad faith.

The Transparency Directive sets out all the requirements that companies listed on European regulated markets have to follow for proper financial reporting; the directive ensures a constant flow of information to the market from its participants (e.g., through mid-year and annual financial reports). All the critical issues related to Wirecard's scandal concern incorrect and misleading financial reporting, which does not comply with the aforementioned directive¹⁵⁸.

Finally, the last regulation worth mentioning is the one regulating the power of intervention of national supervisory authorities in the field of short selling. This regulation gives national supervisors the power to intervene by imposing temporary bans on short selling when economic stability is at risk. The short selling regulation played a significant role in the Wirecard case because in February 2019 Wirecard securities were subject to a short selling ban issued by the BaFin following a drop in the price of the securities of approximately 40% of their value, which led to a distortion of the information available in the market. Through the institution of the short selling ban in fact, BaFin limited volatility only on one side: it was prohibited to sell Wirecard shares, not to buy them. BaFin issued this short selling ban convinced that the attacks received by Wirecard were aimed at manipulating the value of its shares, with the intention of preserving overall financial stability¹⁵⁹.

The pillar on which Wirecard based its fraud was the business model. In fact, Wirecard produced its revenues through a complex network of partner companies, through which it managed to convince the markets and

¹⁵⁸ Langenbucher K., Leuz C., Krahn J. P., and Pelizzoni L. (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

¹⁵⁹ ESMA official website (2019). Search for "ESMA issues positive opinion on short selling ban by BaFin".

investors of the health of its accounts. The company used an opaque scheme of Third-Party Acquirers (TPAs) in order to be able to provide financial services also in distant geographical regions, where it did not have a banking licence. TPAs are partner companies that have a banking licence and allow companies without one to provide payment services as if they had one – like Wirecard did in Asia. In order to exploit this licence, Wirecard had to set aside reserves in escrow accounts for each transaction processed in this way. It was in these escrow accounts that a hole of EUR 1.9 billion was discovered in 2020. Wirecard was able to falsify the company's balance sheet by fudging the transactions of some of its TPAs, to the point that in 2016, three Asian TPAs (Senjo, PayEasy and Al Alam) were responsible for 50% of sales and contributed around 95% of EBITDA¹⁶⁰.

Analyzing the actors involved and the context in which the Wirecard scandal took place, it is possible to identify deficiencies in the supervision of Wirecard. The identified shortcomings concern different levels of supervision of Wirecard, from internal supervision – done by the management and the supervisory committee – to external supervision – done by Ernst & Young in the first instance and by FREP, BaFin and AOB in the second instance. The analysis of the facts showed that all these supervisory bodies did not give due attention to the various allegations made against Wirecard and failed to detect the fraud before it was too late to prevent Wirecard's bankruptcy.

Certainly, Wirecard supervision was made even more difficult by the complexity of the innovative business conducted by the fintech company and the fact that it operated in regions far apart¹⁶¹.

In addition, these supervisory failures could also be due to a structure of the two-tier financial information enforcement procedure. This procedure may have slowed down the reaction time of the supervisory body, since BaFin – the only body with the necessary powers of intervention – can only intervene after the failure of a FREP examination – dealing with the second tier of this procedure. Therefore, the scandal has brought to light the urgent need for a reform of the German supervisory system, which with its current functioning was not able to prevent the collapse of Wirecard despite several warning bells¹⁶².

Following the collapse of Wirecard, in order to assess the implications of this scandal, ESMA was asked by the European Commission to assess the functioning and adequacy of the two-tier financial reporting enforcement procedure specifically in the supervision of the Wirecard case. ESMA has fulfilled this task

¹⁶⁰ McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

¹⁶¹ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

¹⁶² Barba Navaretti G., Calzolari G., and Pozzolo A. F., (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices*.

through one of the new tools made available to it by the 2019 revision of the ESAs, the Fast-Track Peer Review, this analysis echoes the one conducted a few years earlier in 2017 through a Peer Review. The results of this review revealed no evidence of culpability against the two German supervisory bodies – FREP and BaFin. However, after a careful assessment of the facts, ESMA does not exclude the possibility that there may have been an influence of the German government in the actions taken by BaFin, given the very numerous reports regarding Wirecard provided by BaFin to the MoF, often even before making decisions on actions to be pursued¹⁶³.

It is only after this in-depth analysis of the Wirecard case that it is possible to report on the reforms identified as those that could be implemented to prevent similar scandals in the future and that could help make European markets increasingly unified. The identified reforms address some shortcomings of the German supervisory system that emerged from the analysis conducted in the thesis. With the objective to make the German supervisory system stronger and also to achieve greater harmonization of supervision among the 27 European member states. It is only through increasingly uniformed legislative sets and supervisory systems that the European single market can truly be achieved¹⁶⁴.

Indeed, if supervisory practices between states were truly harmonized, it would be possible to avoid legislative arbitrage between EU member states. Moreover, thanks to this harmonization, it might also be possible to establish a single European supervisor of the capital market, trying to reproduce the functioning of the European Central Bank and the Single Supervisory Mechanism.

To achieve such a European operation, a new supervisory body with the necessary powers could be introduced directly or otherwise ESMA could be provided with the necessary powers to effectively achieve centralized and harmonized supervision for the biggest companies in Europe. Such a supervisory system could help prevent the problems associated with national conflicts of interest, the incentive for supervisors to protect domestic companies¹⁶⁵ – the aforementioned *home country bias* – and to minimize risks arising from the collapse of big companies to preserve financial stability.

Germany, in the years immediately following the collapse, has already taken the first steps to react to the Wirecard scandal by adopting a new law that seeks to remedy many of the crucial issues identified in this thesis.

¹⁶³ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA*.

¹⁶⁴ Capriglione F., and Sacco Ginevri A. (2021). Politics and Finance in the European Union. *Law and economics yearly review, Forthcoming*.

¹⁶⁵ Véron N. (2020). The Wirecard Debacle Calls for a Rethink of EU, not just German, Financial Reporting Supervision. *Bruegel and Peterson Institute*.

The new Act on Strengthening the Financial Market Integrity (FISG) is applicable in Germany from 1 July 2021 and provides for stricter requirements regarding the internal and external supervision of German listed companies.

This law introduces some novelties regarding the composition and mandatory formation of supervisory committees dedicated to the supervision of audits and regarding the participation of management in meetings between these committees and audit firms¹⁶⁶.

The FISG also introduces stricter limits on the maximum duration of the relationship between audit firms and audited companies and increases the monetary liability of audit firms in the event of serious failures during the audit¹⁶⁷.

The most important innovation introduced by the FISG, however, is certainly the part of the reform that concerns the structure of the German financial reporting enforcement procedure. The new Act on Strengthening the Financial Market Integrity effectively abolishes the two-tier operation of the procedure. As of 1 January 2022, the FREP has been abolished and consequently all supervisory tasks have been centralized in BaFin, and the FISG provides for an extension of BaFin's rights and competences in order to carry out a more efficient and effective supervision¹⁶⁸.

However, this national supervision system did not work properly in the Wirecard case, as the two bodies were unable to identify the fraud and avoid bankruptcy. Indeed, already the Peer Review conducted by ESMA in 2017 had revealed some weaknesses of the German two-tier supervision system. This analysis in fact revealed that the two German supervisory bodies did not comply with certain GLEFIs issued by ESMA and therefore for example did not have the legal power to request corrective notes on the balance sheet from Wirecard. Furthermore, the 2017 Peer Review found that the two-tier system leaves too much room for ambiguity in the responsibilities and duties of the supervisory bodies involved¹⁶⁹. One of the major criticisms of the supervisory system in the Wirecard case lies in the inability of the supervisory bodies to give sufficient consideration to the constant accusations received by Wirecard from reputable and trustworthy newspapers such as the Financial Times. The FREP, in fact, did not give enough weight to these allegations when conducting its examinations of Wirecard in the first instance, and thus did not further investigate the accounting health of the fintech company. It can be argued, however, that even taking into account the allegations made against Wirecard, identifying the fraud would not have been an easy task.

Moreover, the high level of technology that characterised Wirecard's business and the fact that it operated in countries far apart (Europe and Asia) made it extremely difficult for FREP to identify the accounting fraud.

¹⁶⁶ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁶⁷ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁶⁸ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁶⁹ Krahen J. P., and Langenbucher K. (2020). The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe. *Leibniz Institute for Financial Research SAFE, Frankfurt*.

The rather low pace of financial supervisors' digital transformation and the fast growth in technology leads to an increase in the technological gaps between supervisors and their regions of responsibility and produce a new phenomenon named "asymmetric technology"¹⁷⁰.

As early as 2014, some scholars published a paper arguing that an integrated financial reporting oversight system, not divided between two oversight bodies, would be better able to identify possible frauds and intervene if any were identified¹⁷¹.

However, given the FREP's limited powers of intervention, even if it had had more concrete suspicions, it could not have done anything directly, since its only possibility under the two-tier financial reporting procedure was to inform BaFin of such suspicions. BaFin also failed to take sufficient account of accusations made against German companies when these came from abroad. BaFin – like FREP – mostly ignored the accusations made by the FT journalists, but – unlike FREP – it sometimes argued that these accusations were false and fraudulent, aimed at manipulating the market. In these circumstances, BaFin – convinced of the innocence of the German fintech giant – intervened filing market manipulation charges against Wirecard's accusers. These interventions were made in good faith by BaFin but had distorting consequences on the market¹⁷².

Furthermore, given the numerous reports provided by BaFin to the MoF concerning Wirecard, suspicions arise as to the actual level of independence of BaFin from the German government in performing its duties as national supervisor. This lack of independence, as already seen during the thesis, could be due to a sort of *home country bias*¹⁷³, which may have prompted BaFin to be less strict towards the spearhead of German fintech, Wirecard.

The BaFin also had a distorting effect when it issued a ban on short selling on Wirecard securities to preserve the overall stability of the financial markets, after a series of attacks by short sellers caused them to fall 40%. BaFin issued this short selling ban in good faith, convinced of the willingness of these short sellers to manipulate the market through short selling of Wirecard securities. This intervention had a distorting effect on the market because BaFin – by issuing the short selling ban – limited the volatility of Wirecard securities univocally: Wirecard securities could not be sold, they could only be purchased.

Probably, in order to have fewer distorting effects on the market, BaFin should have resorted to other less invasive instruments, to safeguard financial stability, such as, for example, a suspension of the transactions

¹⁷⁰ Zeranski, S., & Sancak, I. E. (2020). Does the 'Wirecard AG' Case Address FinTech Crises?

¹⁷¹ Wulf I., Niemöller J., and Rentzsch N. (2014). Development toward integrated reporting, and its impact on corporate governance: a two-dimensional approach to accounting with reference to the German two-tier system. *J Manag Control* 25, 135–164.

¹⁷² Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

¹⁷³ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

of the Wirecard securities¹⁷⁴ – both their sale and their purchase. BaFin’s issuance of the short selling ban in February 2021 was the first case in European history in which a national supervisory body issued a two-month short selling ban in defense of a market participant company in order to preserve overall market stability.

Finally, the last supervisory body that has to be mentioned is Wirecard’s auditing firm, Ernst & Young. In fact, EY, as Wirecard’s auditor, was responsible for checking that the company’s financial reports were correct and reliable and that they complied with accounting principles.

During the twelve years in which EY audited Wirecard’s financial statements, the auditing firm failed to identify the fraud and confirmed the financial statements of the fintech giant by relying on the data provided by management in the financial reports. It was only in June 2020 that EY was able – also following the results of the extraordinary audit conducted by KPMG published shortly before – to identify the fraud and refused to confirm Wirecard’s 2019 annual financial statements.

The complexity of the business conducted by Wirecard and the fact that it operated in far-flung locations with different accounting laws certainly contributed to making EY’s task more difficult. However, the length of the auditing relationship between EY and Wirecard raises doubts about the level of independence of the auditing firm vis-à-vis the audited company. The deficiency in the quality of EY’s external audit could also be partly due to a conflict of interest with Wirecard¹⁷⁵. It is important to bear in mind that the auditing firms are paid exclusively by the audited companies, which could give the auditing firms an incentive to be more indulgent in order to safeguard the business relationship¹⁷⁶. Indeed, it seems suspicious that the auditing firm never noticed the missing EUR 1.9 billion, which was supposed to be held in two Philippine banks of which Wirecard was never even a customer. There are still ongoing investigations into EY’s behavior towards Wirecard, the conflict of interest being only one of several possible causes for the lack of quality in the Wirecard audit. The length of the relationship between EY and Wirecard points to a criticality in the German supervisory system, which allows such long-term relationships between auditing firms and audited companies. Germany is already implementing reforms in order to prevent this deficiency.

In addition to the conflict of interest, another possible cause behind EY’s low audit quality could be the very low level of competition in the German audit market. The high concentration of the audit market could lead to a decrease of the general level of audit quality¹⁷⁷.

¹⁷⁴ Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

¹⁷⁵ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹⁷⁶ Beerbaum D. O. (2021). The Future of Audit After the Wirecard Accounting Scandal – Proposal for a Change in the Payment Model.

¹⁷⁷ Kallapur S., Sankaraguruswamy S., and Zang Y. (2010). Audit Market Concentration and Audit Quality.

The audit market in Germany – as in other European countries and more generally in the rest of the world – is virtually 100% concentrated in the hands of four firms, the so-called Big Four. This concentration could lead to a decrease in the effort these firms put into providing quality audits in order to acquire new clients, as they do not need new clients; they already share practically 100% of the market (Brown, 2020). This problem does not only concern Germany but the whole world, and reforms should be implemented to limit this concentration and thus increase the competitiveness of the audit market.

It is important to mention that the **Committee of European Auditing Oversight Bodies** (CEAOB) is the European body in charge of coordinating national oversight bodies of audit firms and harmonizing audit rules; it aims at raising audit quality standards.

After presenting the actors involved, it is necessary to present the **regulatory environment** in which Wirecard perpetrated its fraud, and thus the directives and regulations that were most significant during the unfolding of the collapse of the German fintech. The directives and regulations in force in the European Union that played a key role in the collapse of Wirecard refer to three different topics: the protection of the market from market abuse, the requirement of constant provision of financial information by listed companies to the market, and the provisions regulating NCAs' power of intervention to restrict short selling.

First, the directive and regulation in place to protect the market against **market abuse** have become essential because the fraud perpetrated by Wirecard can be considered as market manipulation. In fact, the company – by publishing false financial statements – influenced the price of its securities and resulted in manipulating the market. Moreover, the German Federal Financial Supervisory Authority has repeatedly used these rules to accuse of market manipulation the authors of the accusations of market manipulation against Wirecard. This over-protective behavior of the German supervisory body – dictated by a kind of *home country bias*¹⁷⁸ – will gain fundamental importance in the analysis of the deficiencies that led to Wirecard's bankruptcy.

The **Transparency Directive** is the law that sets out all the requirements that companies listed on European regulated markets have to follow for **proper financial reporting**; the directive ensures a constant flow of information to the market from its participants (e.g., through mid-year and annual financial reports). This directive is of utmost importance for the analysis of the Wirecard case as all the critical issues linked to the scandal refer to incorrect and misleading financial reporting, which does not comply with the aforementioned directive.

¹⁷⁸ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

Finally, the last regulation worth mentioning is the one regulating the power of intervention of national supervisory authorities in the field of **short selling**. This regulation gives National Competent Authorities (NCAs) the power to intervene by instituting temporary bans on short selling when economic stability is at risk. The short selling regulation played a significant role in the Wirecard case because in February 2019 Wirecard securities were subject to a short selling ban issued by the BaFin following a drop in the price of the securities of approximately 40% of their value, which led to a distortion of the information available in the market. Through the institution of the short selling ban in fact, BaFin limited volatility only on one side: it was prohibited to sell Wirecard shares, not to buy them. BaFin issued this short selling ban convinced that the attacks received by Wirecard were aimed at manipulating the value of its shares, with the intention of preserving overall financial stability¹⁷⁹.

Germany's national supervision system of regulated markets is characterized by a *Two-Tier financial reporting enforcement procedure* with two National Competent Authorities (NCAs): the **Financial Reporting Enforcement Panel (FREP)** – a private company recognized by the German Ministry of Finance, which is in charge of conducting the first tier of examinations – and **Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)** – a German public company reporting directly to the Ministry of Finance (MoF), which intervenes only in exceptional cases for the second tier of examinations.

The Wirecard case showed that something in the German supervisory system did not work. The two supervisory bodies were not able to identify the fraud before it was too late. Moreover, the BaFin intervened several times in defense of Wirecard, denouncing the perpetrators of the accusations and attacks on the German fintech champion. These attacks and accusations against Wirecard almost always came from abroad, as most of them are contained in articles of the Financial Times (FT), and in fact BaFin's over-protective behavior can be seen as a kind of *home country bias*: the need of the German supervisor to protect the German fintech flagship from attacks from abroad. Instead of analyzing and investigating the allegations against Wirecard, BaFin has repeatedly denounced the perpetrators, claiming that their aim was to manipulate the market by publishing false data in order to decrease the value of Wirecard's securities.

Germany's audit market acquires a key role in the Wirecard case because auditing companies are entrusted with the task of verifying the accuracy and correctness of the financial statements published by listed companies and therefore their compliance with the requirements of the Transparency Directive. The body responsible for the supervision of audit firms in Germany is the **Audit Oversight Body (AOB)**. Its objective is to ensure that audit firms perform their work in accordance with the applicable rules, in order to guarantee an adequate standard of audit quality.

¹⁷⁹ ESMA official website (2019). Search for “ESMA issues positive opinion on short selling ban by BaFin”.

The identified shortcomings concern different levels of supervision of Wirecard, from internal supervision – done by the management and the supervisory committee – to external supervision – done by Ernst & Young in the first instance and by FREP, BaFin and AOB in the second instance. The analysis of the facts showed that all these supervisory bodies did not give due attention to the various allegations made against Wirecard and failed to detect the fraud before it was too late to prevent Wirecard's bankruptcy.

The failures that led to the final collapse of the German fintech giant may have been caused also by information problems and supervisory failures.

On the information side, signals and accusations that should have set off alarm bells on Wirecard were ignored. Sometimes, such allegations had the opposite effect to the one intended: BaFin – instead of investigating the veracity of the allegations made against Wirecard – prosecuted the perpetrators, discouraging others from reporting any accounting irregularities identified and contributing to convincing investors that such allegations were unfounded. BaFin's intervention ended up having another distortive effect on the market when it instituted the short selling ban on Wirecard's securities in February 2019, and it limited Wirecard's securities volatility only on one side: it was forbidden to sell the securities, not to buy them. As a result, this action obstructed the markets from incorporating all the information necessary to establish the true market value of the securities.

Wirecard's internal control system and supervisory board – the market's first line of defense against accounting fraud – were unable to prevent the falsification of financial statements and thus the fraud that misled investors.

Deficiencies were related also the external audit, as the firm engaged to audit Wirecard's accounts (i.e., Ernst & Young) was unable to detect fraud for about twelve years. Taking into account that Ernst & Young (EY)'s audit of Wirecard's financial statements focused primarily on mere compliance with accounting standards and not on the detection of frauds, EY failed to give proper weight to the alarm bells that emerged regarding the health of Wirecard's accounts.

Wirecard supervision was made even more difficult by the complexity of the business conducted by the fintech company and the fact that it operated in regions far apart¹⁸⁰.

In addition, these supervisory failures could also be due to a malfunctioning of the two-tier financial information enforcement procedure. This procedure may have slowed down the reaction time of the supervisory body, since BaFin – the only body with the necessary powers of intervention – can only intervene after the failure of a FREP examination – dealing with the second tier of this procedure. Therefore, the

¹⁸⁰ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre.*

scandal has brought to light the urgent need for a reform of the German supervisory system, which with its current functioning was not able to prevent the collapse of Wirecard despite several warning bells¹⁸¹.

Following the collapse of Wirecard, in order to assess the implications of this scandal, ESMA was asked by the European Commission to assess the functioning and adequacy of the two-tier financial reporting enforcement procedure specifically in the supervision of the Wirecard case. ESMA fulfilled this task through one of the new tools made available to it by the 2019 review of the ESAs, the Fast-Track Peer Review. The results of this review revealed no evidence of culpability against the two German supervisory bodies – FREP and BaFin. However, after a careful assessment of the facts, ESMA does not exclude the possibility that there may have been an influence of the German government in the actions taken by BaFin, given the very numerous reports regarding Wirecard provided by BaFin to the MoF, often even before making decisions on actions to be pursued¹⁸².

There are reforms that could be implemented to prevent similar scandals in the future and that could help make European markets increasingly unified. The identified reforms address all the shortcomings of the German supervisory system that emerged from the analysis conducted in the thesis. The objective of these reforms would not only be to make the German supervisory system stronger but also to achieve greater harmonization of supervision among the 27 European member states. It is only through increasingly uniformed legislative sets and supervisory systems that the European single market can truly be achieved¹⁸³. Indeed, if supervisory practices between states were truly harmonized, it would be possible to avoid legislative arbitrage between EU member states. Moreover, thanks to this harmonization, it might also be possible to establish a single European supervisor of the capital market, trying to reproduce the functioning of the European Central Bank and the Single Supervisory Mechanism.

To achieve such a European operation, a new supervisory body with the necessary powers could be introduced directly or otherwise ESMA could be provided with the necessary powers to effectively achieve centralized and harmonized supervision. Such a supervisory system could help prevent the problems associated with national conflicts of interest, the incentive for supervisors to protect domestic companies¹⁸⁴ – the aforementioned *home country bias*¹⁸⁵.

¹⁸¹ Barba Navaretti G., Calzolari G., and Pozzolo A. F., (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices.*

¹⁸² ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA.*

¹⁸³ Capriglione F., and Sacco Ginevri A. (2021). Politics and Finance in the European Union. *Law and economics yearly review, Forthcoming.*

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Germany, in the years immediately following the collapse, has already taken the first steps to react to the Wirecard scandal by adopting a new law that seeks to remedy many of the crucial issues identified in this thesis.

The new Act on Strengthening the Financial Market Integrity (FISG) is applicable in Germany from 1 July 2021 and provides for stricter requirements regarding the internal and external supervision of German listed companies.

This law introduces some novelties regarding the composition and mandatory formation of supervisory committees dedicated to the supervision of audits and regarding the participation of management in meetings between these committees and audit firms¹⁸⁶.

The FISG also introduces stricter limits on the maximum duration of the relationship between audit firms and audited companies and increases the monetary liability of audit firms in the event of serious failures during the audit¹⁸⁷.

The most important innovation introduced by the FISG, however, is certainly the part of the reform that concerns the structure of the German financial reporting enforcement procedure. The new Act on Strengthening the Financial Market Integrity effectively abolishes the two-tier operation of the procedure. As of 1 January 2022, the FREP has been abolished and consequently all supervisory tasks have been centralized in BaFin, and the FISG provides for an extension of BaFin's rights and competences in order to carry out a more efficient and effective supervision¹⁸⁸.

This is not an ending point, but rather a good starting point for a new season of reforms to make European markets more secure, efficient, and uniform.

For the sake of clarity, it is important to mention that investigations and enquiries into the Wirecard case are still ongoing in order to find all the guilty parties in the fraud and the responsibilities of those involved in the supervision process of the fintech giant. This analysis is a contribution that aims at giving major relevance to the investigation on the Wirecard case; moreover, it may be a source of inspiration for future research.

The Wirecard case should not become another forgotten financial scandal, as it is crucial not to waste the opportunity to learn important lessons from this collapse that could contribute to the improvement of the European supervisory system.

This is not an ending point, but rather a good starting point for a new season of reforms to make European markets more secure, efficient, and uniform.

¹⁸⁶ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

¹⁸⁷ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

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List of abbreviations

AML – Anti Money Laundering

AOB – Audit Oversight Body

BaFin – Bundesanstalt für Finanzdienstleistungsaufsicht

BDO – Banco de Oro

BPI – Bank of the Philippine Island

CEAOB – Committee of European Auditing Oversight Bodies

CEO – Chief Executive Officer

Consob – Commissione Nazionale per le Società e la Borsa

CRA – Credit Rating Agency

CRAs – Credit Rating Agencies

DFP – Digital Finance Package

DFS – Digital Finance Strategy

EBA – European Banking Authority

EBITDA – Earning Before Interest Taxes Depreciation and Amortization

EC – European Commission

ECB – European Central Bank

EEA – European Economic Area

EFTA Surveillance Authority – European Free Trade Association Surveillance Authority

EIOPA – European Insurance and Occupational Pensions Authority

ESA – European Supervisory Authority

ESAs – European Supervisory Authorities

ESCMS – European Single Capital Market Supervisor

ESRB – European Systemic Risk Board

ESFS – European System of Financial Supervision

ESMA – European Securities and Markets Authority

EU – European Union

EY – Ernst & Young

FISG – Finanzmarktintegritätsstärkungsgesetz

FREP – Financial Reporting Enforcement Panel

FT – Financial Times

FTPR – Fast-Track Peer Review

GLEFI – Guidelines on the Enforcement of Financial Information

GPDR – General Data Protection Regulation
IPO – Initial Public Offer
ISAs – International Standards on Auditing
JCB – Japan Credit Bureau
MAR – Market Abuse Regulation
MAD II – Market Abuse Directive II
MiFID II – Markets in Financial Instruments Directive
MoF – Ministry of Finance
OCBC – Oversea Chinese Banking Corporation
OECD – Organization for Economic Co-operation and Development
PIEs – Public Interest Entities
POBSA – Public Oversight Bodies for Statutory Auditor
POBSAs – Public Oversight Bodies for Statutory Auditors
PR – Peer Review
PRC – Peer Review Committee
PSD II – Payment Services Directive
PwC – PricewaterhouseCoopers
SdK – Schutzgemeinschaft Der Kleinaktionäre
SRs – Securitization Repositories
SSM – Single Supervisory Mechanism
SSR – Short Selling Regulation
TD – Transparency Directive
TPA – Third-Party Acquirer
TPAs – Third-Party Acquirers
TRs – Trade Repositories
UK – United Kingdom
US – United States
WpHG – Wertpapierhandelsgesetz

Summary

European capital markets are powerful tools for ensuring the proper and efficient allocation of capital but are also extremely vulnerable to misbehavior and fraud perpetrated by bad apples like Wirecard, which undermine their proper functioning. The collapse of Wirecard is neither the first nor certainly the last financial scandal to be perpetrated by falsifying accounts. Scandals like this can be found all over the world, for example in cases such as Enron (USA) and Parmalat (Italy). Such scandals happen regardless of the laws and supervisory systems in place in the countries where they occur, since it is often very difficult to identify accounting fraud before it is too late.

The aim of this thesis is to analyse the implications of the Wirecard case and to see whether there were any supervisory failures in the German two-tier financial information enforcement procedure. Furthermore, the aim is also to present what lessons can be learned from the Wirecard case and what reforms could be implemented to prevent scandals like this from occurring in the future.

Wirecard was a financial services company, flagship of the German fintech market, listed since 2018 on DAX 30, the German market segment that contains the 30 most valued German companies. Wirecard has been the victim of a series of allegations by journalists and investors since 2008, which began in 2008 and lasted until it filed for bankruptcy on 25 June 2020, when it came to light that €1.9 billion in its balance sheet was missing and probably never existed; it caused the value of its shares to immediately drop by more than 95%, from €92.4 per share to €1.4 per share. Wirecard's bankruptcy was the first case in the DAX 30 history in which one of its constituents became insolvent.

The collapse of Wirecard demonstrated to European markets their vulnerability to accounting fraud and the inability of supervisors to ensure compliance with legal requirements, thereby undermining investor confidence in the proper functioning of regulated markets.

Wirecard produced its revenues through a complex network of partner companies, through which it managed to convince the markets and investors of the health of its accounts. The company used an opaque scheme of Third-Party Acquirers (TPAs) in order to be able to provide financial services also in distant geographical regions, where it did not have a banking licence. TPAs are partner companies that have a banking licence and allow companies without one to provide payment services as if they had one – like Wirecard did in Asia. In order to exploit this licence, Wirecard had to set aside reserves in escrow accounts for each transaction processed in this way. It was in these escrow accounts that a hole of EUR 1.9 billion was discovered in 2020. Wirecard was able to falsify the company's balance sheet by fudging the transactions of

some of its TPAs, to the point that in 2016, three Asian TPAs (Senjo, PayEasy and Al Alam) were responsible for 50% of sales and contributed around 95% of EBITDA¹⁸⁹. Due to the high complexity of Wirecard's operations and the fact that Wirecard operated in distant geographical locations (i.e., Asia), it was more difficult for the supervisory authorities to identify the fraud¹⁹⁰.

The German fintech giant – favored by the high technological level of the sector and the remoteness of the geographical locations in which it operated – was able to carry out its fraud undisturbed for more than five years thanks to a complex revenue falsification scheme. The scandal revealed failures in Wirecard's internal and external supervision. Among these, the most critical are related to the functioning of the two-tier financial information enforcement procedure, and the independence of auditors and supervisors. In fact, the German supervision system, as also emerged from the Peer Review conducted by ESMA in 2017, does not present any particular criticalities, but leaves too much room for ambiguity on the responsibilities and tasks of the two bodies involved, the FREP and the BaFin¹⁹¹. What is really striking about the Wirecard case is that for many years the company was accused of accounting fraud and suspicious financial behavior but neither the auditor nor the supervisors were able to identify the fraud. This has brought to light the danger of too long relationships between auditors and audited companies in Germany.

In order to fully understand the Wirecard case, it is first necessary to present all the **actors involved in the supervision process** and the most relevant European directives and regulations.

Among the **European bodies** involved in Wirecard's supervision process, the most noteworthy is the European Securities and Markets Authority (ESMA). ESMA is a body of the **European System of Financial Supervision** (ESFS), which is improperly called a *supervisory* system because its role is primarily that of a *regulator* engaged in the development of rules and best practices for the proper functioning of regulated markets rather than in the actual supervision of the correct rules application; it is involved in direct supervision only in peculiar cases, such as the supervision of specific financial entities.

The European Union has enabled the ESAs to express their judgement and dispense advice on the events that characterize regulated markets through the **Peer Reviews** and – after the 2019 ESAs reform – the **Fast-Track Peer Reviews**. These reviews are assessments of compliance with the guidelines issued by the ESAs, and they have been fundamental in the analysis of the adequacy of supervision in the Wirecard case. This is

¹⁸⁹ McCrum D. (2019). Wirecard relied on three opaque partners for almost all its profit. *Financial Times*.

¹⁹⁰ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre*.

¹⁹¹ Krahen J. P., and Langenbucher K. (2020). The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe. *Leibniz Institute for Financial Research SAFE, Frankfurt*.

the reason why ESMA had a key role in the Wirecard affair: it was charged with assessing – through a Fast-Track Peer Review that consists in evaluating compliance with the guidelines issued by ESMA – the adequacy of the supervision carried out by national supervisors in the Wirecard case.

It is crucial to mention the findings and recommendations that emerged from the Peer Review (PR) and the Fast-Track Peer Review (FTPR) conducted by ESMA in July 2017 and November 2020. The 2017 Peer Review was not specifically focused on BaFin and FREP as it was a review conducted by ESMA to assess the level of harmonization of national supervisory procedures among 31 different eurozone countries. In the 2020 Fast Track Peer Review, ESMA was mandated by the European Commission to form a Peer Review Committee (PRC) to specifically assess the adequacy of BaFin and FREP in carrying out their supervisory role in relation to the Wirecard case. ESMA is engaged in the development of guidelines that national supervisors should implement to ensure proper supervision of capital markets. In particular, the authority is developing the Guidelines on Enforcement of Financial Information (GLEFI) which are best practices that national supervisory authorities should put into practice to ensure proper supervision of financial information disclosed by listed companies. In both the PR and the FTPR, ESMA assesses the harmonization of the various national supervisory systems by evaluating the NCAs' compliance with the Guidelines issued by ESMA. The GLEFIs cover several topics and those most relevant in the Wirecard case are GLEFIs 2, 5 and 6: the adequacy of the number and professionalism of the resources employed by the two NCAs, the adequacy of the level of independence of the two NCAs vis-à-vis government and issuers, and the adequacy of the selection and examination method used by FREP and BaFin in their supervisory process.

Regarding **national supervisors**, in order to clarify the supervisory deficiencies that occurred, it is crucial to analyse the functioning of Germany's peculiar two-tier financial reporting enforcement procedure. In fact, the supervision of financial reporting in Germany – until 1 January 2022 – was characterized by the presence of two cooperating supervisory bodies: FREP, a private body recognised by the MoF; and BaFin, a public body invested with public powers and directly accountable to the Minister of Finance and the MoF.

However, this national supervision system did not work properly in the Wirecard case, as the two bodies were unable to identify the fraud and avoid bankruptcy. Indeed, already the Peer Review conducted by ESMA in 2017 had revealed some weaknesses of the German two-tier supervision system. This analysis in fact revealed that the two German supervisory bodies did not comply with certain GLEFIs issued by ESMA and therefore for example did not have the legal power to request corrective notes on the balance sheet from Wirecard. Furthermore, the 2017 Peer Review found that the two-tier system leaves too much room for ambiguity in the responsibilities and duties of the supervisory bodies involved¹⁹². One of the major criticisms of the supervisory system in the Wirecard case lies in the inability of the supervisory bodies to give sufficient consideration to the constant accusations received by Wirecard from reputable and trustworthy newspapers such as the Financial Times. The FREP, in fact, did not give enough weight to these allegations when

¹⁹² Krahen J. P., and Langenbucher K. (2020). The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe. *Leibniz Institute for Financial Research SAFE, Frankfurt*.

conducting its examinations of Wirecard in the first instance, and thus did not further investigate the accounting health of the fintech company. It can be argued, however, that even taking into account the allegations made against Wirecard, identifying the fraud would not have been an easy task.

Moreover, the high level of technology that characterized Wirecard's business and the fact that it operated in countries far apart (Europe and Asia) made it extremely difficult for FREP to identify the accounting fraud. The rather low pace of financial supervisors' digital transformation and the fast growth in technology leads to an increase in the technological gaps between supervisors and their regions of responsibility and produce a new phenomenon named "asymmetric technology"¹⁹³.

As early as 2014, some scholars published a paper arguing that an integrated financial reporting oversight system, not divided between two oversight bodies, would be better able to identify possible frauds and intervene if any were identified¹⁹⁴.

However, given the FREP's limited powers of intervention, even if it had had more concrete suspicions, it could not have done anything directly, since its only possibility under the two-tier financial reporting procedure was to inform BaFin of such suspicions. BaFin also failed to take sufficient account of accusations made against German companies when these came from abroad. BaFin – like FREP – mostly ignored the accusations made by the FT journalists, but – unlike FREP – it sometimes argued that these accusations were false and fraudulent, aimed at manipulating the market. In these circumstances, BaFin – convinced of the innocence of the German fintech giant – intervened filing market manipulation charges against Wirecard's accusers. These interventions were made in good faith by BaFin but had distorting consequences on the market¹⁹⁵.

Furthermore, given the numerous reports provided by BaFin to the MoF concerning Wirecard, suspicions arise as to the actual level of independence of BaFin from the German government in performing its duties as national supervisor. This lack of independence, as already seen during the thesis, could be due to a sort of *home country bias*¹⁹⁶, which may have prompted BaFin to be less strict towards the spearhead of German fintech, Wirecard.

The BaFin also had a distorting effect when it issued a ban on short selling on Wirecard securities to preserve the overall stability of the financial markets, after a series of attacks by short sellers caused them to fall 40%. BaFin issued this short selling ban in good faith, convinced of the willingness of these short sellers to manipulate the market through short selling of Wirecard securities. This intervention had a distorting effect on the market because BaFin – by issuing the short selling ban – limited the volatility of Wirecard securities univocally: Wirecard securities could not be sold, they could only be purchased.

Probably, in order to have fewer distorting effects on the market, BaFin should have resorted to other less invasive instruments, to safeguard financial stability, such as, for example, a suspension of the transactions of the Wirecard securities¹⁹⁷ – both their sale and their purchase. BaFin's issuance of the short selling ban in

¹⁹³ Zeranski, S., & Sancak, I. E. (2020). Does the 'Wirecard AG' Case Address FinTech Crises?

¹⁹⁴ Wulf I., Niemöller J., and Rentzsch N. (2014). Development toward integrated reporting, and its impact on corporate governance: a two-dimensional approach to accounting with reference to the German two-tier system. *J Manag Control* 25, 135–164.

¹⁹⁵ Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

¹⁹⁶ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹⁹⁷ Alderighi S., and Gurrola-Perez P. (2021). What Does Academic Research Say about Short-Selling Bans? *WFE Research Working Papers, World Federation of Exchanges*.

February 2021 was the first case in European history in which a national supervisory body issued a two-month short selling ban in defense of a market participant company in order to preserve overall market stability.

Finally, the last supervisory body that has to be mentioned is Wirecard's auditing firm, Ernst & Young. In fact, EY, as Wirecard's auditor, was responsible for checking that the company's financial reports were correct and reliable and that they complied with accounting principles.

During the twelve years in which EY audited Wirecard's financial statements, the auditing firm failed to identify the fraud and confirmed the financial statements of the fintech giant by relying on the data provided by management in the financial reports. It was only in June 2020 that EY was able – also following the results of the extraordinary audit conducted by KPMG published shortly before – to identify the fraud and refused to confirm Wirecard's 2019 annual financial statements.

The complexity of the business conducted by Wirecard and the fact that it operated in far-flung locations with different accounting laws certainly contributed to making EY's task more difficult. However, the length of the auditing relationship between EY and Wirecard raises doubts about the level of independence of the auditing firm vis-à-vis the audited company. The deficiency in the quality of EY's external audit could also be partly due to a conflict of interest with Wirecard¹⁹⁸. It is important to bear in mind that the auditing firms are paid exclusively by the audited companies, which could give the auditing firms an incentive to be more indulgent in order to safeguard the business relationship¹⁹⁹. Indeed, it seems suspicious that the auditing firm never noticed the missing EUR 1.9 billion, which was supposed to be held in two Philippine banks of which Wirecard was never even a customer. There are still ongoing investigations into EY's behavior towards Wirecard, the conflict of interest being only one of several possible causes for the lack of quality in the Wirecard audit. The length of the relationship between EY and Wirecard points to a criticality in the German supervisory system, which allows such long-term relationships between auditing firms and audited companies. Germany is already implementing reforms in order to prevent this deficiency.

In addition to the conflict of interest, another possible cause behind EY's low audit quality could be the very low level of competition in the German audit market. The high concentration of the audit market could lead to a decrease of the general level of audit quality²⁰⁰.

The audit market in Germany – as in other European countries and more generally in the rest of the world – is virtually 100% concentrated in the hands of four firms, the so-called Big Four. This concentration could lead to a decrease in the effort these firms put into providing quality audits in order to acquire new clients, as they do not need new clients; they already share practically 100% of the market²⁰¹. This problem does not only concern Germany but the whole world, and reforms should be implemented to limit this concentration and thus increase the competitiveness of the audit market.

¹⁹⁸ Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

¹⁹⁹ Beerbaum D. O. (2021). The Future of Audit After the Wirecard Accounting Scandal – Proposal for a Change in the Payment Model.

²⁰⁰ Kallapur S., Sankaraguruswamy S., and Zang Y. (2010). Audit Market Concentration and Audit Quality.

²⁰¹ Brown M. (2020). Who Audits Public Companies – Germany. *Audit Analytics*.

It is important to mention that the **Committee of European Auditing Oversight Bodies** (CEAOB) is the European body in charge of coordinating national oversight bodies of audit firms and harmonizing audit rules; it aims at raising audit quality standards.

After presenting the actors involved, it is necessary to present the **regulatory environment** in which Wirecard perpetrated its fraud, and thus the directives and regulations that were most significant during the unfolding of the collapse of the German fintech. The directives and regulations in force in the European Union that played a key role in the collapse of Wirecard refer to three different topics: the protection of the market from market abuse, the requirement of constant provision of financial information by listed companies to the market, and the provisions regulating NCAs' power of intervention to restrict short selling.

First, the directive and regulation in place to protect the market against **market abuse** have become essential because the fraud perpetrated by Wirecard can be considered as market manipulation. In fact, the company – by publishing false financial statements – influenced the price of its securities and resulted in manipulating the market. Moreover, the German Federal Financial Supervisory Authority has repeatedly used these rules to accuse of market manipulation the authors of the accusations of market manipulation against Wirecard. This over-protective behavior of the German supervisory body – dictated by a kind of *home country bias*²⁰² – will gain fundamental importance in the analysis of the deficiencies that led to Wirecard's bankruptcy.

The **Transparency Directive** is the law that sets out all the requirements that companies listed on European regulated markets have to follow for **proper financial reporting**; the directive ensures a constant flow of information to the market from its participants (e.g., through mid-year and annual financial reports). This directive is of utmost importance for the analysis of the Wirecard case as all the critical issues linked to the scandal refer to incorrect and misleading financial reporting, which does not comply with the aforementioned directive.

Finally, the last regulation worth mentioning is the one regulating the power of intervention of national supervisory authorities in the field of **short selling**. This regulation gives National Competent Authorities (NCAs) the power to intervene by instituting temporary bans on short selling when economic stability is at risk. The short selling regulation played a significant role in the Wirecard case because in February 2019 Wirecard securities were subject to a short selling ban issued by the BaFin following a drop in the price of the securities of approximately 40% of their value, which led to a distortion of the information available in the market. Through the institution of the short selling ban in fact, BaFin limited volatility only on one side: it was prohibited to sell Wirecard shares, not to buy them. BaFin issued this short selling ban convinced that the attacks received by Wirecard were aimed at manipulating the value of its shares, with the intention of preserving overall financial stability²⁰³.

Germany's national supervision system of regulated markets is characterized by a *Two-Tier financial reporting enforcement procedure* with two National Competent Authorities (NCAs): the **Financial Reporting Enforcement Panel (FREP)** – a private company recognized by the German Ministry of Finance, which is in

²⁰² Jakubeit R. (2021). The Wirecard scandal and the role of BaFin.

²⁰³ ESMA official website (2019). Search for "*ESMA issues positive opinion on short selling ban by BaFin*".

charge of conducting the first tier of examinations – and **Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)** – a German public company reporting directly to the Ministry of Finance (MoF), which intervenes only in exceptional cases for the second tier of examinations.

The Wirecard case showed that something in the German supervisory system did not work. The two supervisory bodies were not able to identify the fraud before it was too late. Moreover, the BaFin intervened several times in defense of Wirecard, denouncing the perpetrators of the accusations and attacks on the German fintech champion. These attacks and accusations against Wirecard almost always came from abroad, as most of them are contained in articles of the Financial Times (FT), and in fact BaFin's over-protective behavior can be seen as a kind of *home country bias*: the need of the German supervisor to protect the German fintech flagship from attacks from abroad. Instead of analyzing and investigating the allegations against Wirecard, BaFin has repeatedly denounced the perpetrators, claiming that their aim was to manipulate the market by publishing false data in order to decrease the value of Wirecard's securities.

Germany's audit market acquires a key role in the Wirecard case because auditing companies are entrusted with the task of verifying the accuracy and correctness of the financial statements published by listed companies and therefore their compliance with the requirements of the Transparency Directive. The body responsible for the supervision of audit firms in Germany is the **Audit Oversight Body (AOB)**. Its objective is to ensure that audit firms perform their work in accordance with the applicable rules, in order to guarantee an adequate standard of audit quality.

The identified shortcomings concern different levels of supervision of Wirecard, from internal supervision – done by the management and the supervisory committee – to external supervision – done by Ernst & Young in the first instance and by FREP, BaFin and AOB in the second instance. The analysis of the facts showed that all these supervisory bodies did not give due attention to the various allegations made against Wirecard and failed to detect the fraud before it was too late to prevent Wirecard's bankruptcy.

The failures that led to the final collapse of the German fintech giant may have been caused also by information problems and supervisory failures.

On the information side, signals and accusations that should have set off alarm bells on Wirecard were ignored. Sometimes, such allegations had the opposite effect to the one intended: BaFin – instead of investigating the veracity of the allegations made against Wirecard – prosecuted the perpetrators, discouraging others from reporting any accounting irregularities identified and contributing to convincing investors that such allegations were unfounded. BaFin's intervention ended up having another distortive effect on the market when it instituted the short selling ban on Wirecard's securities in February 2019, and it limited Wirecard's securities volatility only on one side: it was forbidden to sell the securities, not to buy them. As a result, this action obstructed the markets from incorporating all the information necessary to establish the true market value of the securities.

Wirecard's internal control system and supervisory board – the market's first line of defense against accounting fraud – were unable to prevent the falsification of financial statements and thus the fraud that misled investors.

Deficiencies were related also the external audit, as the firm engaged to audit Wirecard's accounts (i.e., Ernst & Young) was unable to detect fraud for about twelve years. Taking into account that Ernst & Young (EY)'s

audit of Wirecard's financial statements focused primarily on mere compliance with accounting standards and not on the detection of frauds, EY failed to give proper weight to the alarm bells that emerged regarding the health of Wirecard's accounts.

Wirecard supervision was made even more difficult by the complexity of the business conducted by the fintech company and the fact that it operated in regions far apart²⁰⁴.

In addition, these supervisory failures could also be due to a malfunctioning of the two-tier financial information enforcement procedure. This procedure may have slowed down the reaction time of the supervisory body, since BaFin – the only body with the necessary powers of intervention – can only intervene after the failure of a FREP examination – dealing with the second tier of this procedure. Therefore, the scandal has brought to light the urgent need for a reform of the German supervisory system, which with its current functioning was not able to prevent the collapse of Wirecard despite several warning bells²⁰⁵.

Following the collapse of Wirecard, in order to assess the implications of this scandal, ESMA was asked by the European Commission to assess the functioning and adequacy of the two-tier financial reporting enforcement procedure specifically in the supervision of the Wirecard case. ESMA fulfilled this task through one of the new tools made available to it by the 2019 review of the ESAs, the Fast-Track Peer Review. The results of this review revealed no evidence of culpability against the two German supervisory bodies – FREP and BaFin. However, after a careful assessment of the facts, ESMA does not exclude the possibility that there may have been an influence of the German government in the actions taken by BaFin, given the very numerous reports regarding Wirecard provided by BaFin to the MoF, often even before making decisions on actions to be pursued²⁰⁶.

There are reforms that could be implemented to prevent similar scandals in the future and that could help make European markets increasingly unified. The identified reforms address all the shortcomings of the German supervisory system that emerged from the analysis conducted in the thesis. The objective of these reforms would not only be to make the German supervisory system stronger but also to achieve greater harmonization of supervision among the 27 European member states. It is only through increasingly uniformed legislative sets and supervisory systems that the European single market can truly be achieved²⁰⁷. Indeed, if supervisory practices between states were truly harmonized, it would be possible to avoid legislative arbitrage between EU member states. Moreover, thanks to this harmonization, it might also be possible to establish a single European supervisor of the capital market, trying to reproduce the functioning of the European Central Bank and the Single Supervisory Mechanism.

²⁰⁴ Sinisi S., Pozzolo A., Anchino S., Lucantoni P., Macchiavello E. (2020). Webinar - La regolamentazione delle attività fintech: cosa abbiamo imparato dal caso Wirecard? *Centro di Ricerca Interdipartimentale sul Diritto Europeo della Banca e della Finanza, Paolo Ferro-Luzzi, Grandangolo, Università Roma Tre.*

²⁰⁵ Barba Navaretti G., Calzolari G., and Pozzolo A. F., (2020). What are the wider supervisory implications of the Wirecard case? *Economic Governance Support Unit (EGOV) Directorate-General for International Polices.*

²⁰⁶ ESMA staff (2020). Fast Track Peer Review on the application of the guidelines on the enforcement of financial information by BaFin and FREP in the context of Wirecard. *ESMA.*

²⁰⁷ Capriglione F., and Sacco Ginevri A. (2021). Politics and Finance in the European Union. *Law and economics yearly review, Forthcoming.*

To achieve such a European operation, a new supervisory body with the necessary powers could be introduced directly or otherwise ESMA could be provided with the necessary powers to effectively achieve centralized and harmonized supervision. Such a supervisory system could help prevent the problems associated with national conflicts of interest, the incentive for supervisors to protect domestic companies²⁰⁸ – the aforementioned *home country bias*.

Germany, in the years immediately following the collapse, has already taken the first steps to react to the Wirecard scandal by adopting a new law that seeks to remedy many of the crucial issues identified in this thesis.

The new Act on Strengthening the Financial Market Integrity (FISG) is applicable in Germany from 1 July 2021 and provides for stricter requirements regarding the internal and external supervision of German listed companies.

This law introduces some novelties regarding the composition and mandatory formation of supervisory committees dedicated to the supervision of audits and regarding the participation of management in meetings between these committees and audit firms²⁰⁹.

The FISG also introduces stricter limits on the maximum duration of the relationship between audit firms and audited companies and increases the monetary liability of audit firms in the event of serious failures during the audit²¹⁰.

The most important innovation introduced by the FISG, however, is certainly the part of the reform that concerns the structure of the German financial reporting enforcement procedure. The new Act on Strengthening the Financial Market Integrity effectively abolishes the two-tier operation of the procedure. As of 1 January 2022, the FREP has been abolished and consequently all supervisory tasks have been centralized in BaFin, and the FISG provides for an extension of BaFin's rights and competences in order to carry out a more efficient and effective supervision²¹¹.

This is not an ending point, but rather a good starting point for a new season of reforms to make European markets more secure, efficient, and uniform.

For the sake of clarity, it is important to mention that investigations and enquiries into the Wirecard case are still ongoing in order to find all the guilty parties in the fraud and the responsibilities of those involved in the supervision process of the fintech giant. This analysis is a contribution that aims at giving major relevance to the investigation on the Wirecard case; moreover, it may be a source of inspiration for future research.

The Wirecard case should not become another forgotten financial scandal, as it is crucial not to waste the opportunity to learn important lessons from this collapse that could contribute to the improvement of the European supervisory system.

²⁰⁸ Véron N. (2020). The Wirecard Debacle Calls for a Rethink of EU, not just German, Financial Reporting Supervision. *Bruegel and Peterson Institute*.

²⁰⁹ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

²¹⁰ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.

²¹¹ Gatti S. (2021). Wirecard Accounting Scandal Prompts Germany to Act on Financial Market Integrity. *Glass Lewis*.